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U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

WRITTEN COMMENTS

ON

H.R. 2636

THE TECHNICAL CORRECTIONS ACT OF 1987

A BILL TO MAKE TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1986, AND FOR OTHER PURPOSES

VOLUME I

Comments on Title I Through Title VI of the Tax Reform Act of 1986

JUNE 9, 1988

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FOR IMMEDIATE RELEASE
WEDNESDAY, JUNE 10, 1987

PRESS RELEASE #12
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3627

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE INTRODUCTION OF H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced introduction of H.R. 2636, the Technical Corrections Act of 1987, which would make technical corrections to the Tax Reform Act of 1986 and other tax legislation enacted during the 99th Congress.

In introducing the bill, Chairman Rostenkowski stated, "Whenever legislation as large and comprehensive as last year's Tax Reform Act is passed by Congress, some mistakes must be expected in drafting under such extreme time pressures. Clearly, last year's statute is not drafted with technical accuracy in every respect. Unfortunately, a resolution directing the enrolling clerk to correct certain errors and omissions in the legislation (H. Con. Res. 395), was not passed prior to adjournment of the 99th Congress. Therefore, Senator Lloyd M. Bentsen (D., Texas), Chairman of the Senate Committee on Finance, and I instructed our staffs to work together with all the tax-writing staffs of the Congress and the Treasury Department to review the Tax Reform Act of 1986 and make recommendations for technical corrections and clarifications to that legislation. The staff has recently completed its work, and the bill that the Honorable John J. Duncan, Ranking Republican Member of the Committee, and I are introducing today includes necessary technical changes to last year's landmark legislation."

BACKGROUND

The Technical Corrections Act of 1987, H.R. 2636, makes corrections to the Tax Reform Act of 1986, the revenue provisions of the Omnibus Budget Reconciliation Act of 1986, the Harbor Maintenance Revenue Act of 1986, and the Superfund Revenue Act of 1986. This legislation is cosponsored by the Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, and the Honorable John J. Duncan (R., Tennessee), Ranking Republican Member of the Committee on Ways and Means. The Honorable Lloyd M. Bentsen (D., Texas) is introducing an identical bill in the Senate today, cosponsored by the Honorable Bob Packwood (R., Oregon), Ranking Republican Member of the Senate Finance Committee.

In order to assist those interested in the legislation to understand its contents, the staff of the Joint Committee on Taxation will issue a pamphlet in the near future explaining the provisions of the legislation. The Joint Committee print will be available for sale to the general public. It can be obtained at the GPO bookstore or by calling the Superintendent of Documents at (202) 275-3030 and referring to Description of the Technical Corrections Act of 1987, Jacket no. 73-917.

WRITTEN STATEMENTS COMMENTING UPON THE LEGISLATION:

Individuals and organizations interested in commenting upon the provisions of this legislation should submit six (6) copies of their written comments by the close of business, Friday, July 10, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

FOR IMMEDIATE RELEASE
MONDAY, JULY 6, 1987

PRESS RELEASE #15
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3627

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES ANNOUNCES AN EXTENSION OF THE PERIOD FOR SUBMITTING WRITTEN COMMENTS ON H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee has extended, until Friday, July 17, 1987, the time period for submitting written comments to H.R. 2636, the Technical Corrections Act of 1987.

In announcing the extension, Chairman Rostenkowski stated, "I am pleased that many interested members of the public have written the Committee commenting upon H.R. 2636, the Technical Corrections Act of 1987, in response to the Committee's press release dated June 10, 1987. These comments will be very helpful to the Members of the Committee and the staff when the Committee acts on this legislation. Due to the Committee's reconciliation schedule which precludes a public hearing, I am announcing an extension of the date for submission of written comments on H.R. 2636 until July 17, 1987."

BACKGROUND

The Technical Corrections Act of 1987, H.R. 2636, makes corrections to the Tax Reform Act of 1986, the revenue provisions of the Omnibus Budget Reconciliation Act of 1986, the Harbor Maintenance Revenue Act of 1986, and the Superfund Revenue Act of 1986. By press release dated June 10, 1987 (see press release #12), the public was invited to submit written comments on this legislation on or before July 10, 1987. This press release extends the time for filing comments until close of business on July 17, 1987.

WRITTEN STATEMENTS COMMENTING UPON THE LEGISLATION:

Individuals and organizations interested in commenting upon the provisions of H.R. 2636, the Technical Corrections Act of 1987 should submit six (6) copies of thier written comments by the close of business, Friday, July 17, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS BELOW:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

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United Church of Christ Homes, John R. McFadden, letter 902

United Jewish Appeal-Federation of Jewish Philanthropies of New York, Inc., Bernard Rosner, letter 903

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William Penn Charter School, Philadelphia, Pa., William D. Ravdin, letter 914

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- Air Force Village Foundation, San Antonio, Tex., Omar Pitman, letter.
- Albertus Magnus College, New Haven, Conn., Julia M. McNamara, O.P., letter.
- Albright College, Reading, Pa., Patricia N. Moulton, letter.
- All Saints' Episcopal Church, Beverly Hills, Calif., M. Gregory Richards, Rector, statement.
- America's Keswick, Whiting, N.J., William E. Bibik, letter.
- American Baptist Churches, Ministers and Missionaries Benefit Board, New York, N.Y., Dear R. Wright, letter.
- American Baptist Foreign Mission Society, Valley Forge, Pa., William E. Jarvis, letter.
- American Diabetes Association, Oklahoma Affiliate, Inc., Tulsa, Okla., Ann Richards Ketcham, letter.
- American Heart Association, Iowa Affiliate, Mrs. Vicki Kimes, letter.
- American Leprosy Missions, Elmwood Park, N.J., Eugene L. Wilson, letter.
- AMG International, Chattanooga, Tenn., Otto A. Anderson, letter.
- Andrews University, Berrien Springs, Mich., Oliver L. Johnston, letter.
- Anne Carlsen School, Jamestown, N.D., Henry Edwards, letter.
- Arkansas Baptist Foundation, Little Rock, Ark., Harry D. Trulove, letter and attachment.
- Art Center College of Design, Pasadena, Calif., Warren B. Knox, letter.
- Auburn Alumni Association, Auburn University, Ala., Jerry F. Smith, letter.
- Augustana College, Rock Island, Ill., James D. Horstmann, letter.
- Austin College, Sherman Tex.:
  - William R. McLeRoy, letter.
  - J. Thomas Stewart, letter.
- B'nai B'Rith Foundation of the U.S., Sidney H. Closter, letter.
- Baldwin-Wallace College, Berea, Ohio, Thomas H. Konkoly, letter.
- Bangor, Maine, Theological Seminary, Susan L. Grove-Markwood, letter.
- Baptist Bible College & Theological Seminary, Clarks Summit, Pa., Milo Thompson, Jr., letter.
- Baptist Foundation of Oklahoma, Oklahoma City, Okla., Robert L. Ross, W.G. Kersh, and C. Duane Riley, joint letter.
- Baptist Health Services Foundation, Gadsden, Ala., George P. Gray, Jr., letter.
- Baptist Hospital Fund, Midway and Mounds Park Hospitals, St. Paul, Minn., James B. Field, letter.
- Barlow, Argus S., Brevard, N.C., letter.
- Bates College, Lewiston, Maine, Eugene G. Taylor, letter.
- Baylor University Medical Center Foundation, Dallas, Tex., Dan T. Garrett, letter.
- Bellevue College Foundation, Bellevue, Neb., Patricia J. Morocco, letter.
- Berea College, Berea, Ky., Lou S. Lakes, letter.
- Betheny College, Lindsborg, Kansas, R. Jay Ribble, and Donald E. Trued, letters.
- Bethphage Mission, Inc., Omaha, Neb., David A. Jacox, letter.
- Bible Literature International, Columbus, Ohio, James R. Falkenberg, President.
- Biola University, La Mirada, Calif., Gary R. Boren, letter.
- Blair Academy, Blairstorn, N.J., Mary C. Tychonievich, letter.
- Bongard, Diane, Cincinnati, Ohio, letter.
- Bowling Green State University, Bowling Green, Ohio, Dwight F. Burlington, and John H. Fogel, letters.
- Boys Club of Fort Worth, Tex., Tracey Brown, letter.
- Bradley University, Peoria, Ill., Ian T. Sturrock, letter.
- Brebeuf Preparatory School, Indianapolis, Inc., M. Joseph Casey, S.J., letter.

Bremwood Lutheran Children's Home Society, Waverly, Iowa, Harold Hunter, letter.
Brevard College, Brevard, N.C., Mark A. Bailey, letter.
Brockport College of the State University of New York, Patric S. Madama, letter.
Bryan College, Dayton, Tenn., Kenneth G. Hanna, letter.
Buckner Baptist Benevolences, San Antonio, Tex., Micheal Nealeigh, letter.
Buena Vista College, Storm Lake, Iowa, J. Robert Siefer, letter.
Bush School, Seattle Wash., John R. Corkran, letter.
Calhoun School, New York, N.Y., Marilyn Stuart, letter.
California Lutheran University, Thousand Oaks, Calif., Jerry H. Miller, letter.
California State Polytechnic University, Pomona, Calif., Reginald E. Kirven, letter.
California State University, Dominguez Hills, Carson, Calif., Kenneth W. Finlay, letter.
California State Polytechnic University, Pomona, Calif., Reginald E. Kirven, letter.
Callahan, Timothy A.R., Birmingham, Ala., letter.
Calumet College, Whiting, Ind., Father Ronald J. Schiml, C.PP.S., letter.
Calvin College and Seminary, Grand Rapids, Mich., John Heerspink, letter.
Campbellsville, Ky., College, Kenneth H. Pope, letter.
Canton, Ohio, Christian Home, Larry Burgett, letter.
Capper Foundation, Topeka, Kansas, Edward F. Gibbons, and Monty E. Nelson, joint letter.
Carle Foundation, Urbana, Ill., W. Frank Elston, letter.
Carlisle Group, Carlisle, Pa., George W. Bahner, letter.
Case Western Reserve University, Frances Payne Bolton School of Nursing, Cleveland, Ohio, Sandra Deller, letter.
Catholic Archdiocese of Seattle, Wash., Steve Kocharhook, letter.
Catholic Chancery, Diocese of Kansas City-St. Joseph, Mo., Denis Putthoff, letter.
Catholic Charities of the Archdiocese of Dubuque, Iowa, James L. Yeast, letter.
Catholic Foundation, Dallas, Tex., Hal F. Tehan, letter.
Catholic Missions Office, Diocese of Joliet, Ill., Rev. John P. Driscoll, letter.
Cedarville, College, Cedarville, Ohio, Martin E. Clark, and Robert K. Rohm, letters.
Center for Creative Studies, Detroit, Mich., Dennis E. Moore, letter.
Chaddock, Quincy, Ill., Marge Ozley.
Cheyenne Mountain Zoological Park, Colorado Springs, Colo., Karen Murray, letter.
Chicago School of Professional Psychology, Kathleen Slomski, letter.
Chicago Lung Association, John L. Kirkwood, letter.
Chicago School of Professional Psychology, Kathleen Slomski, letter.
Child Evangelism Fellowship Inc., Warrenton, Mo., Paul E. Blackburn, statement.
Children's Hospital, Phoenix, Ariz., Barbara L. Grier, letter.
Children's Hospital Foundation, Denver, Colo., Herman J. West, letter.
Children's Hospital National Medical Center, Washington, D.C., Terry L. Lierman, and Thomas D. Walsh, joint letter.
Children's Mercy Hospital, Kansas City, Mo., Lawrence A. McAndrews, letter.
Christian Appalachian Project, Lancaster, Ky., William A. Begley, letter.
Christian Church in the Upper Midwest, Des Moines, Iowa, James S. Kratz, letter.
Christian Record Braille Foundation, Inc., Lincoln, Neb., Vernon L. Bretsch, letter.
Christian Reformed Home Missions, Grand Rapids, Mich., R. Jack De Vos, letter.
Church of Jesus Christ of Latter-Day Saints, Ron S. Taylor, letter.
Cincinnati, Ohio, Country Day School, William H. Hopple, III, letter.
City of Hope, Cincinnati, Ohio, Herbert E. Ostrov, Ruth J. Preston, Mary Bridget Reilly, and Diane Bongard, letters.
Claremont School of Theology, Claremont, Calif., David H. Nienas, letter.

Clark University, Worcester, Mass., Rilchard P. Traina, letter.
Clarke College, Dubuque, Iowa, Catherin Dunn, and Therese Mackin, letters.
College of Du Page, Glen Ellyn, Ill., D. Richard Petrizzo, letter.
College of Idaho, Caldwell, Idaho, W. Michael Born, letter.
College of Mount S. Joseph on the Ohio, Cincinnati, Ohio, Mary Declan Browne, letter.
College of New Rochelle, N.Y., Sister Dorothy Ann Kelly, O.S.U., letter.
College of Saint Rose, Albany, N.Y., John C. Barner, letter.
College of St. Francis, Jolliet, Ill., Stephen F. Stauffenberg, letter.
College of Wooster, Ohio, Grace M. Tompos, letter.
Colgate University, Campaign for Colgate, Hamilton, N.Y., Donald F. Martin, letter.
Columbia College, Columbia, South Carolina, Robert T. Barham, letter.
Columbia College, Columbia, Mo., Ralph E. Glenn, letter.
Columbian Fathers, St. Columbans, Nebr., Rev. John M. Lagomarsino, letter and attachment.
Community Counselling Service Co., Inc., Western Division, San Francisco, Calif., Michael A. DeNunzio, letter.
Concordia College, Moorhead, Minn., David M. Benson, letter.
Concordia College, Ann Arbor, Mich., Thomas A. Fitchett, letter.
Concordia College, Bronxville, N.Y., Hans G. Springer, letter.
Concordia College of St. Paul, Minn., Michael D. Flynn, letter.
Conservative Baptist Foundation of Arizona, Phoenix, Ariz., Paul G. Spears, letter.
Corcoran School of Art, Washington, D.C., Sally J. Smith, letter.
Cornell College, Mount Vernon, Iowa, David Marker, letter.
Corpus Christi, Texas, Diocese of, Rev. Randy Majek, letter.
Council on Health & Human Services, Wisconsin Conference/United Church of Christ, Dennis Streiff, letter.
Culver Educational Foundation, Culver, Ind., Channing E. Mitzell, letter.
Cumberland Presbyterian Church, Board of Finance, Foundation and Management, Memphis, Tenn., Don Alexander, letter.
Dakota Wesleyan Univesity, Mitchell, S.D., Stan Haidle, letter.
De Moines, Iowa, Diocese of, Nancy Perazelli, letter.
Deaconess Foundation, Cleveland, Ohio, Susan Ell, letter.
Denison University, Granville, Ohio., J. Leslie Hicks, Jr., letter.
Denver Conservative Baptist Seminary, Denver, Colorado, Donald D. Orivs, letter.
Dickinson College, Carlisle, Pa., A. Lee Fritschler, letter.
Dominick, Frank, Dominick, Fletcher, Yeilding, Wood & Lloyd, Birmingham, Ala., letter.
Donald A. Campbell & Company, Inc., Chicago, Ill., Thomas G. Sanberg, letter.
Drew University, Madison, N.J., Steven Kavanaugh, letter.
Drexel Hill, Pa., School of the Holy Child, Sr. Barbara Foy, SHCJ, letter.
Drexel University, Philadelphia, Pa., Carolyn A. Sprogell, letter.
Drury College, Springfield, Mass., Kathy S. Evans, letter.
Dubuque, Iowa, Archdiocese of, Fr. John J. O'Connor, letter.
Eagle Village, Inc., Hersey, Mich., Willard P. Hedberg, letter.
East Carolina University, Greenville, N.C., Micah D. Ball, letter.
Eastern College, Eastern Baptist Theological Seminary, St. Davids, Pa., William R. Rueckle, letter.
Eastern Mennonite High School, Harrisonburg, Va., Les Helmuth, letter.
Elyria, Ohio, United Methodist Home, Charles V. Watt, letter.
Episcopal Church Center, New York, N.Y., Frederick Osborn III, letter.
Episcopal High School, Alexandria, Va., Nathaniel H. Acker, letter.
Erie Diocesan Mission Office, Father Daniel J. Kresinski, letter.
Eureka College, Eureka, Ill., George A. Hearne, letter.
Evangelical Covenant Church, Chicago, Ill., LeRoy M. Johnson, letter.
Evangelical Free Church of America, Minneapolis, Minn., Gene Jones, letter.
Evangelistic Faith Missions, Bedford, Ind., Rev. J.B. "Juddie" Peyton, letter.
Fairfield, Conn., University, James E. Reilly, letter.
Family Service Detroit and Wayne County, Mich., Mary Jane Michaels, letter.
Fay School, Southborough, Mass., Martin Haley, letter.

FCNL Education Fund, Washington, D.C., Edward F. Snyder, letter.
Fellowship of Reconciliation, Nyack, N.Y., John Horn, letter.
Florida Institute of Technology, Melbourne, Fla., Keener Smathers, letter.
Florida Presbyterian Homes, Inc., Lakeland, Fla., Daniel D. Dickenson, letter.
Florida State University Foundation, Tallahassee, Fla., Paula S. Fortunas, letter.
Florida United Methodist Children's Home, Enterprise, Fla., Charles H. Goodrich, letter.
Fort Sanders, Foundation, Knoxville, Tenn., Paul G. Alexander, letter.
Four County Mental Health Services, Inc., St. Charles, Mo., Karl Wilson, and Jill Ditchik, joint letter.
Fox Chase Cancer Center, Philadelphia, Pa., Sandra W. Weckesser, letter.
Frantzreb, Arthur C., Arthur C. Frantzreb, Inc., McLean, Va., letter.
Freed-Hardeman College, Henderson, Tenn., E. Claude Gardner, letter.
Freedom from Hunger Foundation, Davis, Calif., John Logan, letter.
Friends of Israel Gospel Ministry, Inc., Bellmawr, N.J., William E. Sutter, Fred Hartman, Marvin J. Rosenthal, and William C. Varner, joint letter.
Friends of Mercy, Springfield, Ohio, John E. Pickarski, letter.
Geisinger Foundation, Danville, Pa., H.W. Wieder, Jr., letter.
General Conference Auditing Service, Washington, D.C., O. Richard Caldwell, letter.
Georgia Baptist Foundation, Inc., Atlanta, Ga., Donald L. Folsom, letter.
Georgian Court College, Lakewood, N.J., Sister Barbara Williams, letter.
Georgetown College, Georgetown, Ky., R. Richard Carlton, letter.
Girl Scouts, Plymouth Bay Girl Scout Council, Inc., Taunton, Mass., Robert A. Lewis, letter.
Gonzaga University, Spokane, Wash., Jane Orr, letter.
Good Samaritan Society, Sioux Falls, S.D., Raymond L. Mehl, and Randy Fitzgerald, joint letter.
Goodman, Woodrow, Upland, Calif., letter.
Goodwill Industries of Pittsburgh, Goodwill Industries of Fayette County, Uniontown, Pa., and Goodwill Plaza, Inc., Pittsburgh, Pa., Donna M. DeBlasis, letter.
Gordon Technical High School, Chicago, Ill., Robert R. Morris, letter.
Gordon-Conwell Theological Seminary, South Hamilton, Mass., Donald L. Stahl, letter.
Grace Brethren Financial Planning Service, Winona Lake, Ind., Russel H. Dunlap, letter.
Grace Day Home, Sacramento, Calif., Sister Jeanne Rollins, OSF, letter.
Grand Rapids, Mich., Baptist College & Seminary, Norman O. House, letter.
Grant Hospital Development Foundation, Columbus, Ohio, statement.
Green Mountain College, Poultney, Vt., Christian Allan King, letter.
Groton School, Groton, Mass., Glenn W. Boynton, letter.
Harbor Day School, Corona del Mar, Calif., Lucinda M. Marder, letter.
Hardin-Simmons University, Abilene, Tex., Carlyle B. Hayes, letter.
Harding University, Searcy, Ark., C. Alvin Fowler, letter.
Hargrave Military Academy, Chatham, Va., William C. Amidon, letter.
Harker Academy, San Jose, Calif., Susan C. Covey, letter.
Hartwick College, Oneonta, N.Y., Meryl E. Best, letter.
Harvard University, Graduate School of Business Administration, Ellen W. Ryan, letter.
Haven of Rest Ministries, Los Angeles, Calif., J.P. Atkinson, letter.
Haverford School, Haverford, Pa., Murray Dodge, letter.
Hilton Head, S.C., Preparatory School, Caroline G. McGee, letter.
Hogue, Louise N., Bronxville, N.Y., letter.
Holy Cross Hospital Foundation, Fort Lauderdale, Fla., Lana C. Wingerson, letter.
Holy Family College, Philadelphia, Pa., Margaret Swoboda Kelly, letter.
Hospital Association of Metropolitan St. Louis, Mo., Stephen E. Dorn, letter.
Houghton College, Houghton, and West Seneca, N.Y., Ralph C. Young, letter.
Illinois Baptist State Association, Springfield, Ill., Craig A. Ridings, letter.
Incarnate Word College, San Antonio, Tex., Thomas K. Flofchan, letter.

Indiana University Foundation, Bloomington, Ind., Timothy L. Seiler, letter.
Indiana University of Pennsylvania, The Foundation, Anthony F. Lenzi, letter.
Indianapolis, Ind., Art League, Joyce A. Sommers, letter.
Intermed-USA, Inc., Dooley Foundation, New York, N.Y., Verne Chaney, M.D., letter.
Intermountain Deaconess Home for Children, Helena, Montana, Gwen Williams, letter.
International Children's Care, Inc., Terry D. Gobel, letter.
International Voluntary Services, Inc., Donna G. Lucas, letter.
InterVarsity Christian Fellowship, Madison, Wis., John Swenson, letter.
James Madison University, Harrisonburg, Va., Don R. Moore, II, letter.
Jamestown College, Jamestown, N.D., James S. Walker, letter.
Jewish Community Foundation, Boca Raton, Fla., Arthur H. Jaffe, letter.
Jewish Federation of St. Louis, Mo., William Kahn, letter.
Johnson, William K., Bloomington, Ill., letter.
Jones, Westley J.A., Stockton, Calif., letter.
Junior Achievement of the Chisholm Trail, Inc., Fort Worth, Tex., Carolum Martchenke, letter.
Kaniecki, Michael J., S.J., Bishop of Fairbanks, Alaska, letter.
Kassouf, L. Paul, CPA, L. Paul Kassouf & Co., Birmingham, Ala., letter.
Kentucky Baptist Foundation, Middletown, Ky., Barry G. Allen, letter.
Kentucky Baptist Homes for Children, Middletown, Ky., Tom Moore, letter.
Kimberton Waldorf School, Kimberton, Pa., Terry Neville, letter.
King's College, Wilkes-Barre, Pa., Rev. Laurence M. Olszewski, letter.
Kirksville College of Osteopathic Medicine, Kirksville, Mo., Phillip E. Messner, letter.
Kiski School, Slatsburg, Pa., Malcolm S. Hayden, letter.
Kiwanis Camp Wyman, Eureka, Mo., E. Battle Smith, letter.
Lake Forest College, Lake Forest, Ill., William R. Lowery, letter.
Lamar University System, Beaumont, Tex., W.S. "Bud" Leonard, letter.
Lancaster Country Day School, Lancaster, Pa., letter.
Lancaster, Pa., Community Hospital of, Elizabeth A. Kauffman, letter.
Landrebe, Robert S., Carol Stream, Ill., letter and attachment.
Lasell Junior College, Newton, Mass., John McDonagh, letter.
Lee Holthaus & Associates, Wheaton, Ill., Lee Halthaus, letter.
Lenni-Lenape Girl Scout Council, Inc., Butler, N.J., Marjorie G. Price, letter.
Lenoir-Rhyne College, Hickory, N.C., Clarence L. Pugh, letter.
Lewis & Clark College and Law School, Portland, Ore., Eugene R. Gregory, letter.
Lexington Theological Seminary, Lexington, Ky., James M. Wray, Jr., letter.
Lincoln Memorial University, Harrogate, Tenn., Gary J. Burchett, letter.
Loma Linda University, Loma Linda, Calif., George Carambot, letter.
Long Island College Hospital, Brooklyn, N.Y., Barbara J. Kohuth, letter.
Longwood College, Farmville, Va., Donald Lee Lemish, letter.
Louisville Presbyterian Theological Seminary, Louisville, Ky., Anne S. Caldwell, letter.
Loyola University, New Orleans, La., Charles E. Young, letter.
Lubbock Christian College, Lubbock, Tex., Steven S. Lemley, letter.
Lutheran Church in America Foundation, New York, N.Y., Kenneth C. Feinour, Jr., letter.
Luzerne County Community College Foundation, Nanticoke, Pa., Westley E. Franklin, letter.
Maitland Art Center, Maitland, Fla., Ethel Eber Scures, letter.
Malvern Preparatory School, Malvern, Pa., John P. Wilwol, letter.
Manhattan Christian College, Manhattan, Kansas, Wendell Sack, letter.
March of Dimes Birth Defects Foundation, Central California Chapter, Fresno, Calif., Lynne R. Senn, letter.
Marist College, Poughkeepsie, N.Y., Anthony J. Cernera, letter.
Mary Baldwin College, Staunton, Va., Garth A. Mills, Sr., letter.
Marylhurst College, Marylhurst, Ore., Nancy Wilgenbusch, letter.
Maryville College, St. Louis, Mo., Mary Konrad Feller, letter.

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Statement of the
American Bankers Association
Submitted to the
Committee on Ways and Means
U.S. House of Representatives
July 16, 1987

The American Bankers Association (ABA) is pleased to submit comments on H.R. 2636, The Technical Corrections Act of 1987. The ABA is the national trade and professional association for America's commercial banks of all sizes and types. Assets of ABA member banks are about 95 percent of the industry total.

Non-resident Alien Deposits

The ABA fully supports the language of Section 112(f)(4) of the bill which clarifies that the Tax Reform Act of 1986 (TRA'86) provision on the source of income rules for certain interest on deposits was not intended to change the treatment of those deposits for estate tax purposes. The tax code has long excluded from tax interest on deposits held for non-resident aliens. The TRA'86 simply changed the nature of this exclusion from a source rule exclusion to the specific exemption from the U.S. withholding tax. However, once the source rule was changed, bank deposits held by NRAs were inadvertently treated as U.S. property for purposes of the U.S. estate tax.

The clarification effectively incorporates the withholding tax exemption into the estate tax provision and applies as of the date that the withholding tax exemption was enacted. Thus, no federal estate tax would be applied against the deposits in a U.S. bank held by a non-resident alien even if the non-resident alien died after the date of the TRA'86 but before the date of enactment of the Technical Corrections bill.

In addition, the ABA urges the Committee to clarify that the change in the form of the exemption for interest paid to non-resident alien depositors was not intended to result in any additional information reporting with respect to those accounts. Both the Form 1099 reporting requirements under Section 6049 and the Form 1042S reporting requirement under the Section 1461 regulations already contain authority to exempt from reporting payments of interest to foreign depositors. There is no record of abuse that would justify imposing new reporting regulations on these accounts at this time. Moreover, U.S. banks should not be required to report about non-resident alien depositors who rely on the confidentiality of their banking relationship in the U.S. If that confidentiality were breached because of an IRS reporting requirement, those depositors might be in jeopardy of legal or extra-legal sanctions in their home country. It should be clear that the imposition of information reporting on non-resident alien depositors would likely force those depositors to withdraw their funds from U.S. banks and thereby undercut the purpose of the Section 871 and Section 881 exemptions from tax for deposit interest.

Accrual of Income on Short-term Obligations

The ABA believes that the change included in Section 118(d) of the bill needs to be expanded to include provisions similar to those contained in H.R. 2323.

The TRA'86 expanded the scope of Internal Revenue Code (IRC) Section 1281 to require all banks, regardless of their method of accounting, to accrue income on short-term obligations acquired after September 27, 1985. The Technical Corrections bill changes the effective date to obligations acquired after December 31, 1985. This change should eliminate the need for banks on the cash method, mostly smaller institutions located in the Midwest and West, to file amended returns for 1985. Many banks, however, have already filed their returns for 1986, not realizing this provision was included in the TRA'86.

Section 1281 was enacted as part of the Deficit Reduction Act of 1984 (DRA'84) and required banks to include in income currently the acquisition discount on short-term obligations. The Committee reports accompanying the DRA '84 indicate clearly that the rationale for the change was to discourage the leveraged acquisition of Treasury bills and other discounted obligations. There was no indication at that time that the provision was intended to cover short-term loans made by banks. The change to Section 1281 included in the Technical Correction section of the TRA '86, which expanded its application to loans made in the ordinary course of a trade or business, went largely unnoticed.

In addition, the broad question of whether a corporation can use the cash method of accounting was fully debated during consideration of the TRA'86. As a result corporations will be required to use the accrual method of accounting for tax purposes after December 31, 1986, with an exception for small businesses with gross receipts of $5 million or less. Moreover, the Senate provision limiting cash accounting, which would have applied to all banks, was dropped in conference in favor of the $5 million rule. Therefore, application of Section 1281 to loans made in the ordinary course of a trade or business undermines both the policy decision and the effective date decision made with respect to the general provision on cash accounting.

The ABA recommends that the revision of Section 1281 be made effective for obligations acquired after December 31, 1986, coincident with the change for cash accounting and that there be an exception to the application of Section 1281 to short-term loans made in the ordinary course of a trade or business by small banks on the cash method of accounting similar to the provisions contained in H.R. 2323.

Carryover of Pre-1987 Foreign Tax Credits by Financial Institutions.

The ABA recommends that the Technical Corrections Act address an inequitable and possibly unintended consequence in the IRC Section 904 transition rules enacted last year concerning the carryover of foreign withholding taxes incurred in pre-1987 years. The ABA recommends that foreign taxes paid prior to 1987 by banks and other taxpayers predominantly engaged in the banking business should be carried forward to the financial services income basket. This rule should apply both to income taxes on financial services income and withholding taxes on cross-border loan income to the 33 countries listed in the transition rule.

The general intent of the conferees was to permit taxpayers to carryforward pre-1987 unused credits without penalty. Indeed the conferees specifically adopted a Senate provision for taxpayers predominantly engaged in the active conduct of banking, financing, or similar business under which "pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on financial services income" (Conference Report II-585). The Secretary was given specific authority under Section 904 (d)(2)(I)(ii)(II) to provide that for taxpayers engaged in the active conduct of banking, financing or similar business all taxes paid or accrued with respect to income subject to the pre-1987 overall limitation would be treated for carryforward purposes as paid or accrued with respect to financial services income.

Any proposals to have pre-1987 credits put in the overall basket or the high withholding basket would give the TRA'86 a serious retroactive effect. At the time these loans were made, all banking income was in a single basket for foreign tax credit purposes. The conferees' action to grandfather certain existing loans from the high withholding tax basket argues against any retroactive treatment. All banks and other similarly situated taxpayers should be able to carryforward these credits to the financial services basket because any other rule will undermine the grandfather rule. It would create the rather illogical situation of permitting foreign taxes on certain cross-border loans to be included in the financial services basket during the 1987-1989 period and partially during the 1990-1994 phase out period, but that foreign taxes from the same loans earned in prior years would be subject to the new high withholding tax regime immediately.

Net Operating Losses

Section 903(a) of the TRA '86 amended Internal Revenue Code Section 172 to provide that commercial banks will be subject to the same net operating loss carryback and carryover rules as other corporation i.e. 3 years back and 15 years forward. Section 903(b) of the TRA '86 also amended IRC Section 172 to provide an exception to this general rule. If a commercial bank incurs a net operating loss for a taxable year beginning before January 1, 1994 which is attributable to a bad debt deduction allowed under the specific charge-off method, the loss shall be carried back 10 years and carried forward 5 years.

The ABA recommends that the statute allow the bank the option of using either the general corporate rules for the entire net operating loss or the bad debt exception.

The bad debt exception is a relief provision which was included in the TRA '86 to alleviate to a certain extent the repeal of the bad debt reserve method and its negative impact on the deferred tax accounts that commercial banks are required to maintain for financial and regulatory accounting purposes. It also appears that the exception was intended to provide relief for those banks which are incurring economic losses attributable to loan problems which could benefit from the retention of the 10 year carryback provision.

Many institutions which are having loan problems have already incurred large economic losses and have used up the ability to carry net operating losses back. These institutions, which are truly in need of a relief provision, should not be forced to use the bad debt exception when they would benefit most from being allowed to use the general rule providing a longer carryforward period in which to use these losses. If the bad debt exception was intended in part to provide relief for these institutions with bad debt problems then the purpose would be better served by allowing flexibility in the use of the provision.

Alternative Minimum Tax

The ABA recommends that the Committee consider a revision to address a possibly unintended gap in the effectiveness of the alternative minimum tax credit. Section 701 of the TRA '86 amended Internal Revenue Code Section 55 to impose an alternative minimum tax on corporations as well as other non-corporate taxpayers. New IRC Section 53 was also enacted to allow a credit for a prior year minimum tax liability. When a taxpayer pays alternative minimum tax, this tax generally is allowed as a credit against the regular tax liability of the taxpayer in a subsequent year. The minimum tax credit is allowed only with respect to the net minimum tax liability arising as a result of deferral adjustments and preferences and cannot be used to reduce minimum tax liability in subsequent years.

It appears that the minimum tax credit was enacted to ensure that the same amount of income would not be taxed under both the regular tax system and the alternative minimum tax system. In fact the credit appears to work well when a corporation claims a deduction on its tax return in one year and an expense on its financial statements in a subsequent year. It does not work as well when an expense is shown on the financial statement in one year but is not deductible for tax purposes until a subsequent year.

Attached are two examples which show the inequity of the situation. In Example 1 the corporation has a $200 expense for book purposes in 1987 which cannot be deducted for tax purposes until 1988. In Example 2 a corporation has a $200 deduction for tax purposes in 1987 which is not expensed for book purposes until 1988. At the end of 1988 in both examples, the two year cumulative book income amount is $50 and the two year cumulative taxable income amount is $50. In Example 1 the corporation has paid $27 in tax on $50 of (book and tax) income while in Example 2 the corporation has paid $17 of tax on the same amount of income. In these simplified examples, if there are no differences between book and taxable income in 1989, the discrepancy is resolved.

Congress has recognized in recent tax legislation that the time value of money is important. Therefore, it does not seem fair to have two corporations with the same amount of total income paying different amounts of tax. It appears that one possible solution to this situation would be to provide a carryback mechanism for the AMT credit. The carryback could be limited to allow a refund only to the extent that the AMT is attributable to deferral items.

Premium Amortization

Section 643 of TRA '86 amended IRC Section 171 to state that except as otherwise provided in regulations the deduction for amortizable bond premium is treated as interest expense. The ABA recommends that an exception be included in the statute that the amortizable bond premium not be considered interest expense for purposes of IRC Section 291(e)(1)(B)(iii) and Section 265(b)(4)(A).

Premiums paid on bonds represent an adjustment to the coupon rate on the bond. When this premium is paid on a taxable obligation it is a direct expense of acquiring the obligation and should be reflected as an offset to the income generated by such obligation. If the premium amortization is called interest expense for a financial institution, it may be considered part of the total interst expense subject to disallowance for purchasing or carrying tax exempt obligations. As noted above, premium amortization on a taxable obligation is a direct expense of acquiring a taxable obligation. It appears from the Conference Report and from discussions with the Joint Committee staff that the provision was included in the TRA'86 in order to make the deduction subject to the investment interest limitation for individuals and was not intended to cover financial institutions.

Although the statute does allow regulatory flexibility with respect to exceptions to this rule, a regulation project on this issue does not appear to be a priority for the Internal Revenue Service anytime in the near future. Therefore, the ABA recommends that the statute be amended to provide that premium amortization on taxable bonds not be considered interest expense for purposes of determining interest expense attributable to the purchase of tax exempt obligations.

* * * * *

Our Association appreciates the opportunity to comment on the Technical Corrections legislation. Additional information may be obtained from Henry Ruempler, Tax Counsel, American Bankers Association, 1120 Connecticut Avenue, N.W., Washington, D.C., 20036, (202) 663-5317.

American Bankers Association
Statement on H.R. 2636, Technical Corrections Act of 1987

Attachment

Summary - Example 1

	Book Income (Loss)	Current Tax Liability
1987	(100)	34
1988	150	(7)
1989	200	58
Total	250	85

Example 1

Assumptions:
1) 1987 is the corporation's first year operations
2) Loan Loss provision is the only difference between book income and regular taxable income.
3) Loan loss provision expensed for books in 1987, is deducted on the tax return in 1988.
4) Maximum corporate income tax rate is 34% for all years.

1987

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	100	100	
Loan Loss Prov.	(200)	-	
Tax Income	(100)	100	100
Tax		34	20

1988

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	150	150	
Loan Loss Prov.	-	(200)	
Tax Income	150	(50)	(50)
Book Income Adj.			100
Amt Income			50
Tax			10
NOL Carryback-Refund		(17)	

1989

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	200	200	
Loan Loss Prov.	-	-	
Tax Income	200	200	200
Book Income Adj.			-
AMT Income			200
Tax Before Credit		68	40
AMT Credit		(10)	
Tax		58	

Summary - Example 2

	Book Income (Loss)	Current Tax Liability
1987	100	-0-
1988	(50)	17
1989	200	68
Total	250	85

Example 2

Assumptions:
1) 1987 is the corporation's first year of operation.
2) Loan Loss Provision is the only difference between book income and regular taxable income.
3) Loan Loss Provision deducted on 1987 return is expensed on the books in 1988.
4) Maximum Corporate income tax rate is 34% for all years.

1987

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	100	100	
Loan Loss Provision	-	(200)	
Tax Income	100	(100)	(100)
Book Income Adj.			100
AMT Income			-0-
Tax		-0- (NOL Cfwd)	-0-

1988

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	150	150	
Loan Loss Provision	(200)	-	
NOL Carryforward	-	(100)	
Tax Income	(50)	50	50
Tax		17	10

1989

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	200	200	
Loan Loss Prov.	-0-	-0-	
Tax Income	200	200	200
Tax		68	40

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July 8, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

This letter is written by me as special tax counsel for the Trust Division of the American Bankers Association (the "ABA") regarding H.R. 2636, the Technical Corrections Act of 1987.

A. Section 108(e) of the Bill; Common Trust Funds and Taxable Years

As stated in the Joint Committee on Taxation Description of H.R. 2636, the Tax Reform Act of 1986 did not change the taxable year to be used by a common trust fund taxed under IRC Sec. 584. Section 108(e) would amend IRC Sec. 584 by adding a new subsection (h) requiring that the taxable year of such a fund to be the calendar year and making this change effective for 1987. The ABA urges that this change not be made effective until 1988. Certain steps are required in order for a common trust fund to change its reporting period, including (1) securing the approval of the bank's board of directors, (2) securing the approval of the Comptroller of the Currency, (3) securing the approval of the Internal Revenue Service and (4) giving notice of the change to co-fiduciaries and others at least a stated period before its effective date. Also, computer programs for common trust funds must be changed for 1987 and this cannot be done in a short period of time. The Act will in all likelihood not be passed before October 1987. The time remaining in 1987 to complete the actions required to change common trust funds from fiscal years to a calendar year will not be sufficient to get the job done in 1987.

Congress should not pass laws which cannot be complied with in the time period given. Further, the ABA does not believe any revenue loss would result from delaying the change until 1988 because it believes the revenue estimates for 1987 did not include any amount for requiring a common trust fund to use a calendar year.

B. Section 101(e) of the Bill; Deductions for Costs of Administration of Trusts and Estates

This provision would amend the last sentence of IRC Sec. 67(c) to authorize regulations whereby deductions of a trust or an estate will not be taken out of the 2 percent floor rule. The present last sentence of IRC Sec. 67(c) does not authorize such regulations and would therefore not disallow any indirect deduction through a trust or an estate. The Description prepared by the Staff of the Joint Committee on Taxation in explaining the change states (p. 7) that regulations could "apply the 2 percent floor at the beneficiary level rather than at the entity level, to the extent that income is distributed to beneficiaries." The ABA believes the change is not clarifying but rather is substantive and, as such, does not belong in a technical amendments act.

C. Section 111A(f) of the Bill; Tax on Excess Retirement Accumulation

An election would be provided to permit a spouse of an individual who "is the beneficiary of all of the interests" in qualified plans to have the excess distribution rule apply instead of having a supplemental estate tax imposed on the excess retirement accumulation. The statutory language is unclear whether the election may be made when the beneficiary is a trust but the spouse is the sole beneficiary of the trust, as would be the case with an IRC Sec. 2056(b)(5) trust. The ABA recommends that the statutory language be changed to clarify that an election be made when the spouse is the sole beneficiary of a trust named to receive the plan proceeds.

D. Section 114(b) of the Bill; Special Rule for Reversionary Interest

IRC Sec. 673 would be amended by the addition of a new subsection (c) stating that for purposes of subsection (a) the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of the grantor. This is a substantive change which should be effective only for transfers made after June 10, 1987.

E. Section 114(f) and (g) of the Bill; the GST Tax

In general, the ABA believes the proposed changes relating to the generation-skipping transfer tax imposed by Chapter 13 of the Code are helpful. However, as discussed below, (1) two of these changes (see items 2b and 5) are not designed to "correct or clarify" but rather are substantive changes which as such should be rejected as being inconsistent with the purpose of a Technical Corrections Act, (2) one change (item 3) is uncertain in meaning and may be read to produce one, two or three undesirable results which complicate the operation of the GST tax, (3) one change (item 4) has technical problems that need to be corrected, and (4) one change (item 2a) is unnecessary and is based upon an incorrect interpretation of current law.

1. Direct Skips and Taxable Terminations

IRC Sec. 2612(a) would be amended to add a new paragraph (3) stating that the term "taxable termination" shall not include a "direct skip." This paragraph should be modified to add after the words "direct skip" "determined without regard to [the $2 million grandchild exemption] and section 2612(c)(2)."

2. Charitable Transfers

a. Deduction

A new section (IRC Sec. 2625) would be added allowing a charitable deduction. The purpose of the section is explained in the Description of the Technical Corrections Act of 1987 prepared by the Joint Committee on Taxation as follows (page 262):

> For example, where property is placed in a trust which is to pay an annuity to the transferor's child for life, then an annuity to the transferor's grandchild for life with the remainder to go to charity at the grandchild's death, the amount subject to the generation-skipping transfer tax at the child's death is reduced by the value of the charitable remainder interest determined as of the child's death.

A charitable deduction is not needed in this case because no GST tax is imposed at the child's death. IRC Sec. 2652(c)(1) provides that charity is deemed to have an interest in a charitable remainder trust and, therefore, a taxable termination cannot occur with such a trust.

IRC Sec. 2625 is unnecessary and confusing and should not be added to Chapter 13.

b. Inclusion Ratio

A "related" change would amend IRC Sec. 2642(a)(2)(B)(ii) to remove the reference to any charitable deduction allowed by IRC Sec. 2055 or 2522 in computing the "applicable fraction" and the "inclusion ratio" of a trust. The fact that this change is substantive and not clarifying is made clear by applying it only to transfers made after June 10, 1987.

The determination to permit the value of a charitable transfer to be subtracted in computing the inclusion ratio of a trust was deliberate and had its genesis in the Treasury simplification proposal (H.R. 6260). The ABA participated with the Treasury in the development of its proposal, which involved compromises of conflicting views. Permitting the charitable deduction to be subtracted in computing the inclusion ratio was "offset" by making the termination of the interest of charity in a charitable lead trust a taxable termination rather than a direct skip to the extent trust property passed to grandchildren of the transferor. If the computation of the inclusion ratio is changed, the taxable termination result should also be changed. Nevertheless, the ABA submits neither change should be made and current law should be continued.

3. Separate Share Rule

A sentence would be added to IRC Sec. 2654(b) to state:

> Except as provided in the preceding sentence, nothing in this chapter shall be construed as authorizing a single trust to be treated as 2 or more trusts.

The Joint Committee Description is not helpful in determining what is intended by the sentence. Read literally, it does nothing because no provision in Chapter 13 authorizes a single trust to be treated as 2 or more trusts, except the first sentence of IRC Sec. 2654(b). However, an "undisclosed" meaning could be given to the proposed new sentence in one or more of three areas with undesirable results.

If the sentence is intended to prevent a trustee from dividing a trust that has an inclusion ratio of neither 1 nor zero into two trusts, one with an inclusion ratio of 1 and the other with an inclusion ratio of zero, we believe the change should not be made because it puts an emphasis on draftsmanship that is undesirable and will increase the expenses of administering trusts. Clearly, the draftsperson can accomplish the desired objective by providing that to the extent property added to a trust would cause the trust to have an inclusion ratio of more than zero such property shall not be added but rather shall be held as a separate trust upon the same terms as the "other" trust. Also, the one trust or two trust issue was addressed in the proposed regulations under IRC Sec. 2056(b)(7), which permit the division of a single marital deduction-credit shelter trust portion into two trusts, one not qualifying for the deduction and the other consisting of the marital deduction portion. See prop. Reg. §20.2056(b)-7(e), Example (11). The policy considerations are the same for each case and therefore the result should be the same - a division of a single trust into two trusts should be "permitted."

The change in the separate share rule might also be interpreted to prevent the use of a single QTIP trust and an allocation of the creator's GST exemption to a part of the trust. To illustrate, suppose T has an estate of $2 million and creates a credit shelter trust of $600,000 and a QTIP trust of the balance of his estate. The executor desires to make an election under IRC Sec. 2652(a)(3) as to $400,000 (4/14ths) of the trust. The surviving spouse's executor would then allocate her GST exemption to the balance of the trust property after her death. Arguably, the proposed new sentence is intended not to permit partial elections as to a QTIP trust. We disagree with such a result and do not understand why the creation of two trusts should be required in order to permit GST exemptions to be allocated thereto by each spouse.

The sentence could also justify a wrong result in allocating the GST exemption. Assume T creates a marital deduction QTIP trust which provides that upon the death of T's spouse the trust property is to be divided into two equal shares. The first share continues in trust for T's son. The second share continues in trust for T's descendants, and a Chapter 13 transfer as to this share would occur at the death of T's spouse. T's executor desires to make an election pursuant to IRC Sec. 2652(a)(3) and then to allocate T's GST exemption only to the second share. This result could be accomplished by creating two equal QTIP trusts. It should also be permitted with a single QTIP trust.

The ABA recommends no change be made in section 2654(b).

4. Use of GST Exemption for Certain Inter Vivos Transfers

A new subsection (e) would be added to IRC Sec. 2642. This subsection contains special rules concerning the inclusion ratio for a trust, and the allocation of the GST exemption to the trust, where an inter vivos transfer is made and the property transferred would be includible in the gross estate of the individual making the transfer (other than by reason of IRC Sec. 2035) if he died immediately after making the transfer. Paragraph (3) directs that if there is a distribution to a skip person before the death of such individual "such distribution shall be treated as a direct skip." This result seems inappropriate in some cases. To illustrate, assume that T creates a trust for his grandchild who is to receive the income for 2 years after which the trust property is to return to T. The first issue is whether subection (e) would apply. An inter vivos transfer is made, but immediately after the transfer only a part but not all of the property transferred would be included in T's estate. Does this mean the subsection does not apply or that it applies only to the actuarial value of T's retained interest? The second issue is whether a distribution to the grandchild is a "distribution to a skip person." The transfer is a direct skip in an amount equal to the value of a 2 year income interest. Does this cause the transferor to change for purposes of determining whether there is a "distribution to a skip person"?

Suppose T creates an IRC Sec. 2503(c) trust for his grandchild and acts as trustee of the trust. The transfer to the trust is a completed gift for gift tax purposes in an amount equal to the full value of the trust property and a direct skip. T should be able to allocate his GST exemption to the trust property. However, this could not be done because the trust property would be included in his gross estate under IRC Sec. 2038 if he died immediately after the transfer.

Subsection (e)(3)(B) states that if a distribution from the trust is a direct skip the transferor "may allocate a portion of his GST exemption to such distribution." This is inconsistent with the deemed allocation during life rule of IRC Sec. 2632(b), which provides that an allocation of the exemption shall be made to lifetime transfers unless the transferor elects out of this rule.

5. Effective Date Rules

a. "Gallo" $2 Million Exemption

Current law creates this exemption for transfers "to" a grandchild of the transferor that are made before January 1, 1990. The exemption would be modified by substituting a new section 1433(b)(3) which restricts its availability for a transfer in trust to a case where the income of the trust must be distributed at least annually to the grandchild after he or she attains age 21. This additional requirement is inconsistent with the instructions for the gift tax return (Form 709 (Rev. January 1987)) which require only that the trust property be vested in the grandchild for estate tax purposes. We know of cases where trusts for a grandchild were created in reliance on these instructions. It is unfair to disallow the exemption in such cases.

Furthermore, we believe mandating a current distribution of income is wrong. The reason for creating the trust may be to provide flexibility that can be achieved only through a trust and granting the trustee discretionary powers regarding the distribution of income or principal. This would be particularly important where the grandchild has a mental or physical illness.

If the income distribution requirement is retained the legislative history should state that in determining whether this requirement is met shall be determined in accordance with the regulations under IRC Sec. 2056(b)(5).

b. Mental Disability

The date for determining whether the decedent was under a mental disability would be changed from the date of enactment, October 22, 1986, to September 25, 1985. This means that if a decedent's mental disability commenced between these two dates property included in his gross estate would be subject to Chapter 13. We believe this result is bad policy. Such a person should be treated no less favorably than an individual who died before October 23, 1986 since mental disability is the same as death in terms of changing the disposition of property.

6. Omissions

a. Previously Taxed Property Credit

Chapter 13 is deficient in failing to provide relief similar to IRC Sec. 2013 when (1) a taxable termination occurs within 10 years of the creation of a trust with property included in a decedent's gross estate, (2) a taxable termination occurs within 10 years of a prior taxable termination regarding the same trust property or (3) a beneficiary receiving property after a taxable termination dies within 10 years of such termination. IRC Sec. 2611(b)(3) may have been intended to provide relief but it is of very limited scope and is not consistent with the approach of IRC Sec. 2013.

The need for relief may be illustrated by a simple case. T creates a trust of property included in his gross estate for his child C who dies 2 years after T's death and the trust property passes to C's surviving issue. Under current law, the trust property is subject to a Chapter 13 tax and the actuarial value of C's interests are eligible for the IRC Sec. 2013 credit in C's estate. Instead, the credit should be allowed to the trust and not to C in computing his estate tax. Also, the nature of C's interests in the trust should be immaterial in determining the amount of the credit.

b. Other Items

The ABA submitted a memorandum dated December 22, 1986 to staff regarding changes needed in Chapter 13. Changes suggested in items 4 (relating to the relationship between IRC Secs. 2511(b)(1) and 2652(a)(1)) and item 6 (relating to IRC Sec. 2612(a)(2)) are not dealt with in the Act. The ABA believes these matters should be addressed. Copies of these items are attached to this letter.

Sincerely yours,

Richard B. Covey
Richard B. Covey

ATTACHMENT

4. Sections 2611(b)(1) and 2652(a)(1). Section 2611(b)(1) creates an exclusion from a taxable termination for a transfer subject to estate tax by an individual assigned to the first generation below the transferor, and section 2652(a)(1) changes the transferor when an estate tax transfer occurs. The two provisions produce inconsistent policy results. Assume A creates a discretionary trust for his son S and S's two children GC1 and GC2. GC1 is given a general testamentary power of appointment and dies before S and exercises his power of appointment in favor of GC2. Section 2611(b)(1) does not apply because GC1 is not in the first generation below A. Under one analysis, the entire trust property appears subject to both Chapter 13 tax (as a taxable termination as to S) and an estate tax in GC1's estate with no offset from the dou-

ble tax unless the amount of the taxable termination is reduced by the estate tax. Under a second analysis, the estate tax is deemed to precede the Chapter 13 tax and no taxable termination occurs because GC2 becomes a non-skip person due to GC1 becoming the transferor as a result of section 2652(a)(1)(A). In any event, if GC1 appoints to S for life with remainder to GC2 or continues the property in a discretionary trust for S and GC2 with remainder to GC2, a Chapter 13 tax is avoided because no taxable termination occurs at GC1's death. Also, because GC1 becomes the transferor, no taxable termination takes place at S's death. This result suggests that the second analysis is correct. However, this analysis has the effect of negating the limitation imposed in section 2611(b)(1).

The result in the case discussed in the preceding paragraph needs to be changed to effectuate the policy of Chapter 13. Since C had an interest in the trust, a taxable termination must occur at the termination of his interest, whether before or after GC1's death. This means the definition of "transferor" must be modified so that no change occurs pursuant to section 2652(a)(1) except when section 2611(b)(1) applies. Also, section 2622(b) should be revised to state that when the same transfer is subject to both estate tax and the Chapter 13 tax the estate tax shall be subtracted in computing the Chapter 13 tax.

The change suggested in section 2651(a)(1) would also apply when a gift tax transfer is made. To illustrate, GC has a vested remainder in a trust A created for his child C and transfers that interest. As a result GC would make a taxable gift equal to the value of the remainder interest. The transferor should not change until after the death of C.

Suppose A creates a discretionary trust by will for his child C and his descendants and gives C an unlimited right to withdraw the entire principal of the trust. Common sense tells us that C should be treated as the transferor for purposes of Chapter 13, but section 2652(a)(1) does not so provide. When C has the power the potential problem is not serious because the exclusion under section 2611(b)(1) will prevent any distribution to C's descendants being a taxable distribution. However, if a grandchild of A was the person with the power, this provision does not apply unless the interest of C is ignored and the creation of the trust is considered as a direct skip. The power of withdrawal situation is also important in terms of reporting requirements for potential Chapter 13 transfers. Section 2652(a)(1) should be modified to change the transferor to the person with the power.

6. Section 2612(a)(2). This paragraph states:

> CERTAIN PARTIAL TERMINATIONS TREATED AS TAXABLE.--If, upon the termination of an interest in property held in a trust, a specified portion of the trust assets are distributed to skip persons who are lineal descendants of the holder of such interest (or to 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.

Its purpose is not clear. Perhaps the explanation is that without the provision a taxable distribution rather than a taxable termination would have occurred and the objective was to have a taxable termination so that the alternate valuation election of section 2624(c) would be available if the termination of the interest was caused by a death. However, why it should be limited in application to a case where the distributees are descendants of the holder of the terminated interest or a trust or trusts for their "exclusive benefit" cannot be explained. Distinctions should not be created between different skip persons.

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July 9, 1987

Mr. Robert J. Leonard
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1102 Longworth House Office Building
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Re: Comments on Proposed Technical Corrections Act of 1987 (Provisions Affecting the Income Taxation of Estates and Trusts)

Dear Mr. Leonard:

The enclosed comments on the proposed Technical Corrections Act of 1987 were prepared by individual members of the American Bar Association Section of Real Property, Probate and Trust Law, Committee on Tax Legislation and Regulations; Income Taxation of Trusts and Estates (B-6). Principal responsibility in this connection was exercised by Richard S. Kinyon, Frederick R. Keydel, Dave L. Cornfeld, and Edward J. Beckwith.

These comments represent the individual views of the members who prepared them, and do not purport to represent the official position of the American Bar Association, or that of the Section of Real Property, Probate and Trust Law.

Sincerely,

Jerry J. McCoy
Washington Coordinator
Probate & Trust Division
ABA Section of Real Property,
Probate and Trust Law

COMMENTS ON THE PROPOSED TECHNICAL CORRECTIONS ACT OF 1987 RELATING TO THE PROVISIONS OF THE TAX REFORM ACT OF 1986 AFFECTING THE INCOME TAXATION OF ESTATES AND TRUSTS

I. TWO PERCENT FLOOR ON MISCELLANEOUS ITEMIZED DEDUCTIONS -- TRA 1986 SECTION 132, CODE SECTION 67

A. Excess Deductions Under IRC Section 642(h)

Arguably the IRC section 642(h)(2) deduction allowed to the beneficiaries of an estate or trust is subject to the two-percent floor, even though all or a portion of that deduction may be a result of administration expenses that would have been allowable in arriving at AGI of the estate or trust under IRC section 67(e) or not otherwise subject to the floor because of section 67(b). Appropriate amendments should be made to sections 67(b) and 642(h) to the effect that the deductions of an estate or trust in its final taxable year should retain their character in the hands of the beneficiaries succeeding to its property, with the beneficiaries' shares of the AGI deductions being deductible against their own AGI, and with their shares of the itemized deductions being subject to their own two-percent floor to the extent not exempted by section 67(b). This might best be accomplished (1) by adding the following new clause (14) at the end of section 67(b):

> "(14) the deduction under section 642(h) (relating to excess deductions on termination of an estate or trust,"

and (2) by adding the following two sentences at the end of IRC section 642(h):

> "Deductions allowable in determining the adjusted gross income of the estate or trust shall first offset the gross income of the estate or trust, and any excess shall be allowable as a deduction in determining the adjusted gross income of the beneficiaries. Itemized deductions of the estate or trust shall have the same character in the hands of the beneficiaries as in the hands of the estate or trust and shall be allocated in the manner provided in section 662(b)."

B. Deduction for Personal Exemption

The law should be clarified so that the two-percent floor does not apply to the deduction for personal exemption of an estate or trust. This might best be accomplished by amending clause (2) of IRC section 63(d) to read as follows:

> "(2) The deduction for personal exemptions provided by sections 151 and 642(b)."

II. ESTIMATED INCOME TAXES OF TRUSTS AND ESTATES -- TRA 1986 SECTION 1404, CODE SECTIONS 643(g) AND 6654(l)

A. Revocable Trusts

A revocable trust should be exempt from the requirement to pay estimated income tax during the first two taxable years following the death of the grantor. Such trusts are commonly used in lieu of probate and have the same problems as those that warrant the two-year exemption for estates. This might best be accomplished by amending IRC section 6654(l) to read as follows:

> "(l) Estates and Trusts. -- This section shall apply to --
>
> (1) any trust other than one that was revocable at the date of the grantor's death, and
>
> (2) any estate, and any trust that was revocable at the date of the grantor's death, with respect to any taxable year ending 2 or more years after the date of the decedent's or grantor's death.
>
> For purposes of this subsection, a revocable trust is a trust that was subject to section 676 at the date of the grantor's death."

B. Section 643(g) Election

New IRC section 643(g), which allows a trustee to elect to treat any portion of a payment of estimated tax made by the trust as a payment made by a beneficiary of the trust, also should be applicable to an estate after its second taxable year, since estates are subject to section 6654 with respect to any taxable year ending two or more years after the date of the decedent's death. Many probate estates must remain open for more than two years, especially where estate tax is payable or litigation is involved. In such a case, the executor may well not know whether final distribution can be made, or at least income can be distributed, during the year at the time the first, second, or third installments are due. If, after payment has been made, the estate is terminated or the remaining income is otherwise distributed to the beneficiaries, it will be necessary to have the payment refunded to the estate rather than credited directly to the beneficiaries. The ability to treat the estimated tax payments as having been made by the beneficiaries would greatly simplify the administration and closing of the estate and avoid the administrative nuisance of refunds for both the government and the estate.

In addition, we see no need for the requirement that the election must be made on or before the 65th day after the close of the taxable year. Even though the Bill amends section 643(g) to allow the election to be made otherwise than on the trust's return, as is the case under IRC section 663(b) for distributions generally, the fiduciary will still need to compute the trust's tax liability in order to know how much of the estimated tax payments to treat as a payment made by a beneficiary. This will still exacerbate the severe problem tax preparers will experience in reporting income of all trusts on a calendar year basis, however, and we recommend that the election be made on a timely filed return with the beneficiaries' shares of the trust's estimated tax payments being credited to them on the Schedules K-1 filed with respect to the trust.

III. DEDUCTION OF INTEREST -- TRA 1986 SECTION 511(b), CODE SECTION 163(h)

A. Estate or Trust Beneficiary's Residence

A technical correction with respect to the allowance of mortgage interest by an estate or trust would be desirable. The interest should constitute qualified residence interest if the property is used as a qualified residence by a beneficiary of the estate or trust. This might best be accomplished by adding the following new subparagraph (C) to IRC section 163(h)(5):

> "(C) Special Rule for Property in an Estate or Trust. -- For purposes of this subsection, any property, which is a qualified residence of a beneficiary of an estate or trust shall be treated as a qualified residence of the estate or trust."

B. Interest on Pecuniary Bequests

Interest on a general cash legacy also should be deductible by an estate or trust. This could be accomplished by presuming that the interest qualifies as investment interest, by providing that it will not be treated as non-deductible personal interest, or by treating the payment of interest as deductible under IRC section 661. This might best be accomplished (1) by adding the following new subparagraph (F) to IRC section 163(h)(2):

> "(F) any amount payable by an estate or trust as interest by reason of delayed payment of any bequest, legacy, or other required distribution,"

or (2) by adding the following phrase at the end of the parenthetical clause in section 661(a)(1):

> "and including any amount payable as interest or otherwise by reason of delayed payment of any bequest, legacy, or other required distribution."

IV. GRANTOR TREATED AS HOLDING ANY POWER OR INTEREST OF GRANTOR'S SPOUSE -- ACT SECTION 1401, CODE SECTION 672(e)

New IRC section 672(e) should be amended to terminate grantor trust treatment if the grantor and his or her spouse cease to be married. Former spouses are frequently hostile to each other, and there is no more reason to impute the power or interest of the grantor's former spouse to the grantor than the interest or power of any other person. IRC section 682 does not cure all possible problems for the grantor, since that section only covers income which the former spouse is entitled to receive. Thus, the grantor of an inter vivos QTIP trust could be taxable on capital gain under IRC section 677 where the trustee has the discretionary power to distribute principal to the former spouse but does not in fact do so. This and other unintended results could be avoided by amending section 672(e)(1), as proposed in the TCA of 1987, to read as follows:

> "(1) In general -- For purposes of this subpart, a grantor shall be treated as holding any power or interest held by the grantor's spouse while they are married."

V. REVERSIONARY INTEREST TAKING EFFECT AT DEATH OF MINOR LINEAL DESCENDANT BENEFICIARY -- ACT SECTION 1402(a), CODE SECTION 673(b)

The Blue Book, at page 1249, provides that in order to apply the exception to the new five-percent reversionary interest rule, under which the grantor is deemed not to have retained a proscribed power or interest in all or a portion of a trust if that interest or power can revert to the grantor only after the death of a lineal descendant of the grantor who is also a beneficiary of that portion of the trust, "the beneficiary whose life is used must have the entire present interest (as defined in sec. 2503(c)) in that trust or portion." Consequently, it appears that the property or the income therefrom in any such trust or portion must be payable only to or for the benefit of the specified beneficiary during his or her lifetime. Clarification as to the meaning of "present interest" in section 673(b) would be helpful.

VI. PASSIVE ACTIVITY LOSSES AND CREDITS -- ACT SECTION 501, CODE SECTION 469

A. Unused Losses and Credits on Termination of an Estate or Trust

IRC section 642(h) should be amended to permit the pass-through of suspended passive activity losses and credits to beneficiaries upon the termination of an estate or trust. This could be done by substituting the following new language after clause (2) of that section:

> "or (3) for the last taxable year of the estate or trust disallowed passive activity loss or passive activity credit under subsections (a) or (b) of section 469, then such carryover or such excess or such disallowed passive activity loss or passive activity credit shall be allowed as a deduction or passive activity loss or passive activity credit, in accordance with regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust."

B. $25,000 Offset for Rental Real Estate Activities

The provisions of IRC section 469(i)(4), permitting an estate to utilize losses from certain rental real estate activities to the extent of $25,000 for two taxable years after the decedent's death, should be extended to a revocable trust (i.e., a trust that was subject to section 676 at the date of the grantor's death).

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July 17, 1987

Robert J. Leonard, Esquire
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Re: Comments on the Technical Corrections Act of 1987

Dear Rob:

I am enclosing comments on the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) as prepared by members of various Tax Section committees. The comments were reviewed by members of the Committee on Government Submissions.

The enclosed comments represent the individual views of the members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

John B. Jones, Jr.
Chair, Section of Taxation

Enclosures

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SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

COMMENTS ON TRANSFER TAX ISSUES RAISED BY THE RETIREMENT EQUITY ACT OF 1984 AND WHICH ARE UNRESOLVED BY H.R. 2636

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

This report was prepared by members of the Committee on Estate and Gift Taxes. Members who participated in preparation of the report are Zoe M. Hicks, Ronald D. Aucutt, Shirley D. Peterson, and John R. Cummins. The comments were reviewed by James Halpern of the Committee on Government Submissions.

Dated: July 7, 1987

AMERICAN BAR ASSOCIATION - SECTION OF TAXATION

RETIREMENT EQUITY ACT - TRANSFER TAX ISSUES PAPER

The following issues have been submitted previously, but were not addressed in the General Explanation or the 1987 Technical Corrections Act, as introduced, and are resubmitted for clarification, as appropriate in the technical corrections, regulations, or announcements. These issues relate to the acquisition or waiver by a nonparticipant spouse of a right granted by the Retirement Equity Act of 1984 (REA). New Code section 2503(f) is a partial solution to the transfer tax questions which arise as a result of rights granted by REA, but additional transfer tax issues remain.

Transfer tax issues raised by REA have been previously discussed in Comments on Section 1552(e)(2) of H.R. 3838, Repeal of Section 2517. Proposed statutory language, which would solve the transfer tax issues, was submitted on March 6, 1986, and is being resubmitted at this time. The Code should make clear that unintended transfer tax consequences do not result under REA.

Section 1: Estate Tax.

1.01 No Waiver of REA Rights.

A. Issue. If a nonparticipant spouse predeceases a participant spouse without having made a waiver of rights granted by REA, is the value of the REA benefits includable in the nonparticipant's gross estate?

B. Discussion. No provision has been made with respect to estate tax consequences of the nonparticipant spouse's failure to waive REA rights. A nonparticipant spouse who predeceases the participant, not having waived REA benefits, should not have such benefits includable in the spouse's estate for estate tax purposes. Or, if includable, the marital deduction should be available to offset the inclusion.

C. Clarification Needed. Unless clarified, the estate tax consequences to the estate of the nonparticipant spouse will remain uncertain.

1.02 Consent to Waiver at Death.

A. Issue. If a nonparticipant spouse consents to a waiver of the spousal annuity at death, has a transfer occurred for estate tax purposes, causing inclusion of the benefits in the nonparticipant spouse's estate under sections 2035 through 2038?

B. Discussion. The fact that new section 2503(f) excludes from the gift tax a waiver of REA rights by a nonparticipant spouse during life arguably creates a negative inference that such a waiver at death may be a transfer for estate tax purposes.

C. Clarification Needed. Where the nonparticipant spouse consents to a waiver of REA rights at death, conformity with new section 2503(f) would require no transfer for estate tax purposes.

Section II: Gift Tax.

A. Issue. What are the gift tax consequences of the acquisition by a nonparticipant spouse of the right to a REA spousal annuity, the payment of a spousal annuity, or the lapse of the right to a REA spousal annuity?

B. Discussion. There is no reference in new section 2503(f) to the gift tax consequences of the acquisition by a nonparticipant spouse of a REA right, of the payment of a REA right, or to the gift tax consequences of the lapse of a REA right.

C. Clarification Needed. Further clarification is needed that neither the acquisition, payment nor lapse of a REA right is deemed a transfer for gift tax purposes.

Proposed Statutory Language

The following statutory language would solve these problems:

Section 2517 (relating to certain annuities under qualified plans) is amended by redesignating subsection (d) as subsection (e) and adding after subsection (c) the following new subsection:

"(d) EXEMPTION OF CERTAIN SPOUSAL ANNUITIES.--

"(1) IN GENERAL.--For purposes of this subtitle, neither--

> "(A) the acquisition by the spouse of an employee of the right to a spousal annuity, nor
>
> "(B) the consent of such spouse, under section 417, to the waiver of a spousal annuity by an employee, nor
>
> "(C) the lapse of any such right to a spousal annuity or any such power to consent to the waiver of a spousal annuity by reason of the death of the employee or the employee's spouse or for any other reason

shall be considered as a transfer by the employee or by the employee's spouse.

"(2) SPOUSAL ANNUITY.--For purposes of paragraph (1), the term "spousal annuity" means--

> "(A) the interest of an employee's spouse in a defined contribution plan as described in section 401(a)(11)(B)(iii)(I),
>
> "(B) the interest of an employee's spouse in any part of a death benefit which is, by the terms of any plan described in section 401(a), subject to the election and spousal consent described in section 417(a) so as to comply with the requirements of section 401(a)(11) as to the entire death benefit,
>
> "(C) a qualified joint and survivor annuity, as defined in section 417(b), and
>
> "(D) a qualified preretirement survivor annuity, as defined in section 417(c)."

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

Comments on Secs. 105(c) and 107(b) of H.R. 2636 and S. 1350
(Technical Corrections Bill, as introduced
on June 10, 1987)

Interest Deduction Limitations
(Secs. 511 and 701 of the Tax Reform Act of 1986)

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

This report was prepared by members of the Committee on General Income Tax Problems, with the assistance of the Real Estate Tax Problems Committee. The member of the Committee on General Income Tax Problems primarily responsible for the comments was Dennis B. Drapkin. Additional comments were received from Richard M. Lipton, William M. Backstrom, Jr., and Michael Hirschfeld. The comments were reviewed by James Halpern of the committee on Government Submissions.

Date: July 14, 1987

Technical Corrections Bill

Interest Deduction Limitations
(Secs. 105(c) and 107(b) of the Technical Corrections Bill)

1. Identification of indebtedness with a particular purpose.

Sections 105(c)(1) and 105(c)(4) of the Technical Corrections Bill would change the statutory rule for establishing a relationship between indebtedness and a particular purpose. These sections would substitute the phrase "properly allocable to" for the phrases "incurred or continued to purchase or carry" (section 163(d)(3)(A)) and "incurred or continued in connection with the conduct of" (section 163(h)(2)(A)), respectively. These changes should be strengthened by express statutory authorization to issue regulations thereunder and by further explanation in the committee reports.

Sections 163(d)(3)(A) and 163(h)(2)(A), as amended or added by the Tax Reform Act of 1986, continue the language found in prior-law section 163(d) which relates indebtedness to a particular purpose. Despite such language and corresponding interpretations, the I.R.S. indicated in Announcement 87-4 (January 5, 1987) that interest expense under revised sections 163(d) and 163(h) must be allocated on the basis of use of the proceeds of the debt. In other words, direct tracing would establish the requisite relationships. This approach is consistently followed in the temporary regulations. Temp. Treas. Reg. § 1.163-8T (July 2, 1987).

In view of the continuation of the relevant language from prior law, at least some question could be raised as to the ultimate validity of regulations incorporating the "tracing" concept. In addition, since the prior-law language had been the subject of interpretation, there was also the possibility of confusion in applying the new principles as one might infer that the interpretation of the language under prior-law would also be carried over.

The proposed statutory changes should make clear that the prior-law relationship principles do not apply to the corresponding provisions of section 163, as revised by the Tax

Reform Act. This means, however, since the statute and legislative history do not provide any relevant guidance, that the regulations must carry the interpretative burden for a critical area of the interest deduction rules. As stated in the "Description of the Technical Corrections Bill of 1987 (H.R. 2636 and S. 1350)," prepared by the Staff of the Joint Committee on Taxation (p. 25), "[t]his change is not intended to suggest the adoption of any particular method of allocation, but rather to give Treasury the ability to devise allocation rules as simple as possible consistent with the objectives of the provision." Accordingly, Treasury is being given almost complete freedom to write rules that relate indebtedness to a particular purpose.

In view of the dearth of guidance and the significance of these regulations, Congress should provide separate legislative authority for these regulations, as was done with respect to similar provisions in the passive activity rules, and should follow the language of section 469(k)(4). Specific statutory authorization is desirable since the rules for relating indebtedness with a particular purpose can no longer be derived from the statute or the legislative history, and such rules are fundamental to applying the new rules for deducting interest. In addition, the legislative history of the Technical Corrections Act should make clear that prior-law interpretations with regard to indentifying indebtedness with a particular purpose will not apply to sections 163(d) and (h), except as may specifically be provided by regulations.

2. Phase-in of investment interest limitations.

Section 105(c)(3) of the Technical Corrections Bill rewrites the phase-in of the investment interest limitations, as set forth in section 163(d)(6)(A). Under the revision, not only will the deletion of the prior-law $10,000 or $5,000 safe harbor be phased in, but so will (i) the reduction of net investment income by passive losses that are allowed under the passive loss phase-in rule and (ii) any adverse impact from including as investment property an interest in any activity that is not treated as passive and in which the taxpayer does not materially participate.

There is an apparent inconsistency between the explanation of the policy underlying the phase-in rule given in the Blue Book (which explanation incorporated the technical correction), and the statutory implementation of that policy, with the result that either the Blue Book is wrong or the statutory phase-in rule is incomplete. As stated in the Blue Book (p. 269), disallowed investment interest during the phase-in period will generally be equal to the sum of "(i) the amount of investment interest that would have been disallowed under prior law plus (ii) the applicable portion of the additional amount of investment interest that would be disallowed once the provision is fully phased in." The statutory phase-in rule, both before and after revision by the Technical Corrections Act, works differently, however, and is not based upon "the amount of investment interest that would have been disallowed under prior law . . ." Instead, the phase-in rule applies only to the three changes identified above. All other modifications to section 163(d) made by the Tax Reform Act of 1986 are immediately effective. Thus, for example, the revised definition of investment property, the inclusion in investment income of long-term capital gain and any positive taxable income or gain attributable to an interest in an activity which is not a passive activity and with respect to which the taxpayer does not materially participate, are all fully phased in.

Accordingly, either the legislative history of the Technical Corrections Act should restate the "policy" underlying the phase-in rule, or the phase-in rule should be further revised to conform to the Blue Book description.

3. Refinancing of qualified residence loans.

Section 105(c)(5) of the Technical Corrections Bill completely rewrites section 163(h)(3)(C), in order to permit, under certain circumstances, the refinancing of pre-August 17, 1986 loans ("old loans") that are secured by a qualified residence to be eligible for the qualified residence interest provision. Under the technical correction, a refinancing loan will be eligible to the extent of the principal amount of the old loan, and, in general, for the duration of the old loan. The Bill provides, however, that if the principal of the old loan is not amortized, then the refinancing loan will remain eligible for its term, up to 30 years, regardless of the term of the old loan. Thus, for example, if the old loan is a "bullet" loan with a three-year term, the refinancing loan may have a term of up to 30 years. If any portion of such old loan is amortized, however, the refinancing loan must mature at the end of the original three-year term of the old loan.

The provisions regarding the eligible term of refinancing loans seem arbitrary and overly generous. Apparently, even if the term of the old loan is of relatively short duration, so long as the principal of the old loan is not amortized over its term, the refinancing loan can have a term of up to 30 years without jeopardizing qualification under the qualified residence interest rules. There is no apparent reason why this should be so.

4. Qualified residence rule: married individuals filing separate returns.

The qualified residence provisions provide rules for married persons filing separate returns that do not properly reflect the results in community property jurisdictions and in other situations. Section 163(h)(5)(A)(ii)(II) requires that in such cases, either each individual will take into account interest with respect to one residence, or one individual will take into account interest with respect to two residences. In a community property jurisdiction, however, each spouse is treated as having made one-half of any interest payment made with community funds. If the spouses have two residences, section 163(h)(5)(A)(ii)(II) imposes an inequitable result, since the spouse to which a residence is allocated cannot deduct the portion of the interest with respect to that residence deemed paid under community property principles by the other spouse, and the interest deemed paid by the other spouse is, by definition, not qualified residence interest. The Senate Report (p. 807) makes clear that the "other spouse" will obtain this unfavorable treatment. The same problem will trap unwary spouses in common law jurisdictions if the "other spouse" makes any interest payments. (The problem apparently may be avoided when only one residence is involved since each spouse will "take into account" the same residence.)

This problem requires a statutory modification. The problem can be avoided in a manner consistent with the underlying policy by requiring both spouses to elect the same two residences if either spouse is to claim interest with respect to more than one residence.

5. Conditions for investment interest carryovers.

Under section 163(d)(3)(E) (prior to its amendment by the 1986 Act), carryovers of investment interest were limited to interest disallowed "solely" by reason of section 163(d). New section 163(d)(2) omits the "solely" requirement.

Under prior law, the "solely" requirement was interpreted to have real effect. In Rev. Rul. 86-70, 1986-1 C.B. 83, investment interest that would not have been deductible currently due to insufficient taxable income and that would not give rise to a net operating loss was held not eligible for an investment interest carryover. See also Ltr. 8525002 (Feb. 15, 1985; technical advice) (same issue).

The implication of the statutory omission is that the rules for investment interest carryovers have been relaxed. If this was not the intention, the word "solely" should be restored to section 163(d)(2).

6. Cooperative housing corporations.

Section 163(h)(5)(B) provides two special rules for cooperative housing corporations. First, indebtedness secured by stock held as a tenant-stockholder under section 216 is treated as secured by the residence to which such stock relates. Second, if such stock may not be pledged, the requisite security relationship may be demonstrated if it is established "that such indebtedness was incurred to acquire such stock."

Section 163(h)(5)(B), by specifically authorizing the establishment of relationships between non-pledgeable section 216 stock and indebtedness incurred to acquire such stock, calls into question how tenant-stockholders are to establish relationships between their residence and qualifying medical and educational expenses and any other expenditures. In other words, if the tenant-stockholder is precluded generally from pledging his cooperative housing stock, how may the tenant-stockholder establish that his residence "secures" any indebtedness, whether or not that indebtedness was incurred to acquire the section 216 stock? If a tenant-stockholder cannot establish such relationships, he will not be able to take full advantage of the qualified residence rules.

The policy underlying section 163(h) should be to place tenant-stockholders of housing cooperatives on approximately equal footing with other owners of residences. Accordingly, the last sentence of section 163(h)(5)(B) should be revised to authorize the establishment of relationships between section 216 stock (and the residence to which it relates) and any indebtedness. Otherwise, tenant-stockholders may be precluded from utilizing the qualified residence interest rules for any indebtedness other than the indebtedness deemed incurred to acquire the section 216 stock.

7. Alternative minimum tax.

Under section 163(h)(2)(D), "qualified residence interest" is excluded from nondeductible personal interest. "Qualified residence interest" is also excluded from the investment interest limitations (section 163(d)(3)(B)(i)), the uniform capitalization rules (section 263A(f)(2)(B)), and the passive activity rules (section 469(j)(7)).

In determining interest deductions for alternative minimum tax ("AMT") purposes, section 56(b)(1)(C)(i) requires the taxpayer to use "qualified housing interest", as defined by section 56(e), in lieu of the much more generous "qualified residence interest." Section 107(b)(3) of the Technical Corrections Bill recognizes that, for AMT purposes, a conforming change must therefore be made to the "qualified residence interest" exclusion from the investment interest limitation. If this conforming change were not made, then for AMT purposes, some interest would be improperly treated as nondeductible personal interest instead of investment interest.

Similar modifications to section 56(b)(1)(C) should be made to reflect the exclusions of sections 263A(f)(2)(B) and 469(j)(7). Section 58(b)(1), relating to the AMT treatment of passive activity losses, does not appear to solve the problem since it leaves the section 469(j)(7) exclusion intact.

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

COMMENTS ON THE TECHNICAL CORRECTIONS ACT OF 1987 NATURAL RESOURCES ISSUES

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

The comments were prepared under our direction by individual members of the committee on Natural Resources of the Section of Taxation. Principal responsibility was exercised by Kenneth E. Updegraft, Jr. The proposals were reviewed by John S. Harper of the Section's Committee on Government Submissions.

COMMENTS ON H.R. 2636 TECHNICAL CORRECTIONS BILL OF 1987

This memorandum will comment on three matters pertaining to section 1254 of the Code, as enacted by section 413(a) of the Tax Reform Act of 1986, which are not addressed in the Technical Corrections Bill of 1987, but which should be covered in that legislation. These three matters concern:

1. the double "recapture" of hard mineral exploration expense incurred on properties "placed in service" after December 31, 1986;
2. the failure to provide for "recapture" of intangible drilling and development costs incurred after December 31, 1986 on foreign properties "placed in service" before January 1, 1987; and
3. the clarification of the effective date provision applicable to section 1254 of the Code, which is set forth in section 413(c) of the Tax Reform Act of 1986.

I. Double Recapture of Exploration Expense.

Prior to the enactment of section 1254 by section 413(a) of the Tax Reform Act of 1986, hard mineral exploration expense was subject to recapture pursuant to section 617 of the Code in one of two ways, as follows:

First, if any mine on the property in respect of which such exploration expense was incurred reached the producing stage, recapture was accomplished pursuant to section

617(b) of the Code. Under section 617(b)(1)(B) depletion deductions under section 611 of the Code with respect to minerals produced from that property were disallowed until the amount of depletion disallowed equalled the amount of the previously deducted exploration expense incurred on that property. Alternatively, for the year in which the mine reached the producing stage, the taxpayer could elect pursuant to section 617(b)(1)(A) to include in gross income the previously deducted exploration expense incurred with respect to the property on which that mine was located.[1]

Second, if no mine on the property ever reached the producing stage or if, in the case of a producing mine, recapture was not accomplished in full pursuant to section 617(b), then, in either such case, if the taxpayer ever disposed of the property in a taxable transaction, any gain realized on the disposition was subject to recapture under section 617(d) to the extent of the unrecaptured exploration expense.

Section 413(a) of the Tax Reform Act of 1986 enacted section 1254 (hereinafter referred to as "New Section 1254") to provide, in the case of hard mineral properties, for a more expansive concept of recapture applicable in the event of a taxable disposition of a mining property than was required under section 617(d). The Tax Reform Act of 1986 did not repeal section 617(d); however, by the addition of section 617(d)(5) it rendered that subsection inapplicable to hard mineral properties subject to New Section 1254 (see Tax Reform Act of 1986, § 413(b)). The Tax Reform Act likewise did not amend or repeal sections 617(b) and 617(c) of the Code. However, unlike the manner in which the "overlap" problem created by section 617(d) and New Section 1254 was dealt with in the Tax Reform Act, the Act failed to provide for coordination between recapture required under sections 617(b) and 617(c), on the one hand, and New Section 1254, on the other. As explained below, the Act's failure to provide for coordination among those sections of the Code results in double recapture of hard mineral exploration expense incurred on properties which are "placed in service" after December 31, 1986 and, thus, subject to New Section 1254.

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[1] Section 617(c) sets forth a somewhat similar rule which operates to disallow depletion on lease bonus and royalty payments received in connection with a leasing or subleasing transaction involving a mineral property in respect of which exploration expenses were previously incurred and deducted currently.

New Section 1254 requires, in the event of a taxable disposition of a hard mineral property "placed in service" after December 31, 1986, recapture of "the aggregate amount of expenditures which have been deducted by the taxpayer . . . under section . . . 617 with respect to such property . . ." (New Section 1254(a)(1)(A)(i)), assuming such amount is less than the amount of gain realized on such disposition. New Section 1254 does not, however, provide for any offset for exploration expense previously recaptured pursuant to section 617(b) or 617(c).2/ As a result, all exploration expenses incurred on hard mineral properties "placed in service" after December 31, 1986 will be subject to recapture twice: initially, when any mine located on that property reaches the producing stage, pursuant to section 617(b) (or pursuant to section 617(c), if the property is disposed of in a leasing or subleasing transaction, irrespective of whether any mine on such property ever reaches the producing stage); and secondly, when the property (or any part of it), including any non-operating interest retained in a leasing or subleasing transaction, is subsequently disposed of in a taxable transaction, pursuant to New Section 1254(a). The Congress clearly could not have intended this result.

In order to remedy the foregoing technical defect in New Section 1254, specific statutory language should be adopted

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2. Because the Tax Reform Act of 1986 did not amend or repeal either section 617(b) or section 617(c), it is clear that those sections remain applicable to mineral properties which are "placed in service" after December 31, 1986 and which are thus subject to New Section 1254.

in connection with the enactment of H.R. 2636 which specifies the manner in which the recapture provisions of sections 617(b) and 617(c) are to be coordinated with New Section 1254. This could be accomplished in one of two ways, as follows:

first, the following parenthetical language could be inserted in New Section 1254(a)(1)(A)(i) immediately after the reference therein to section 617:

> "(minus the amount of any such expenditures which have been recaptured pursuant to section 617(b) or 617(c))"; or

second, a new subsection could be added to New Section 1254, which could read as follows:

> "In the case of any expenditures deducted pursuant to section 617, paragraph (1)(A)(i) hereof shall not apply to any such expenditures to the extent such expenditures have been recaptured by the taxpayer or any person pursuant to section 617(b) or section 617(c)."

II. Failure to Provide for Recapture of IDCs Incurred on Certain Foreign Properties.

Prior to the enactment of the Tax Reform Act of 1986, the deductibility of all intangible drilling and development costs (herein "IDCs") was governed by section 263(c) of the Code. The predecessor version of New Section 1254 (referred to herein as "Old Section 1254") required the recapture of "expenditures . . . deducted as intangible drilling and development costs under section 263(c) . . ." (Old Section 1254(a)(1)(A)). (emphasis added.) When the Congress enacted the Tax Reform Act of 1986, it made a number of statutory and conforming changes regarding the deductibility of IDCs and the recapture of such IDCs. These included:

1. The addition of subsection 263(i), providing for the treatment of IDCs paid or incurred on foreign oil, gas and geothermal properties. This change was effective generally for IDCs paid or incurred after December 31, 1986, in taxable years ending

after that date. As a result of this change, IDCs paid or incurred after December 31, 1986 with respect to foreign properties are no longer governed by section 263(c); their tax treatment is governed solely by section 263(i).

2. The complete replacement of Old Section 1254 with New Section 1254. New Section 1254 is applicable generally only to properties "placed in service" after December 31, 1986 (see Tax Reform Act of 1986, § 413(c)). Old Section 1254 continues, however, to remain applicable to all oil, gas and geothermal properties which are not subject to New Section 1254. Unlike Old Section 1254, which only required recapture of IDCs deducted pursuant to section 263(c), New Section 1254 requires the recapture of all "expenditures . . . deducted . . . under section 263 . . ." (emphasis added).

Foreign oil, gas and geothermal properties "placed in service" prior to December 31, 1986 (hereinafter referred to as "Pre-1987 Foreign Properties") are not subject to New Section 1254, but remain subject to Old Section 1254. Furthermore, IDCs paid or incurred after 1986 with respect to Pre-1987 Foreign Properties are not governed by section 263(c) of the Code, but rather are subject to section 263(i). Accordingly, it appears that such IDCs are not subject to recapture under any provision of the current Code or prior tax law. This conclusion appears technically correct because such IDCs are not subject to recapture under New Section 1254, and Old Section 1254 only provides for the recapture of IDCs deducted pursuant to section 263(c); Old Section 1254 by its express language does not extend to IDCs subject to section 263(i). Clearly, the Congress did not intend this result.

It is obvious that the foregoing technical oversight created by the Tax Reform Act of 1986 should be remedied. The simplest way to correct this oversight would be to amend Old Section 1254(a)(1)(A) to delete the reference therein to subsection (c) which follows the reference in that section to section 263, so that, as amended, Old Section 1254 would apply to all "expenditures . . . which have been deducted . . . under section 263 . . ."

III. Effective Date of New Section 1254.

New Section 1254 is effective for any oil, gas, geothermal or hard mineral property which is "placed in service" after December 31, 1986, with one exception (see Tax Reform Act of 1986, § 413(c)). The exception concerns the "exception for binding contracts" which is set forth in section 413(c)(2) of the Tax Reform Act.

The "placed in service" concept which the Tax Reform Act adopted to establish the effective date of New Section 1254 is one that has never previously been used to prescribe the date on which a new tax provision that has exclusive applicability to a natural resource operation will become effective. Consequently, there is no precedent that one may look to in order to determine what that concept may mean and how it is to be applied in the case of a specific oil, gas, geothermal or mining operation. Because the concept of "placed in service" is totally foreign to the extractive industries, the use of this concept in establishing the effective date of New Section 1254 has created confusion and substantial potential for controversy, which is totally unnecessary.

In order to eliminate the confusion and potential for controversy which the "placed in service" concept in New Section 1254 has created, it is suggested that the effective date provision applicable to that section be clarified. It is not intended that such clarification cause the effective date provision of New Section 1254 to be any more or less liberal than the current provision, which appears in section 413(c) of the Tax Reform Act of 1986. Rather, the clarification in all respects should perpetuate the spirit of what the Tax Reform Act intended. To eliminate controversy, however, alternative concepts which the extractive industries clearly understand should be utilized.

To permit all of the foregoing to be accommodated, it is suggested that the effective date provision of New Section 1254 be restated as follows:

1. In the case of any oil, gas or geothermal property, New Section 1254 would apply to any such property which on December 31, 1986 was not a proven property;
2. In the case of any other mineral property, New Section 1254 would apply to any such property which on December 31, 1986 did not contain a mine which, as of such date, was in the producing stage, as such term is defined in Treas. Reg. § 1.616-2(b);
3. Except for the use of the two suggested alternative concepts described above, the "exception for binding contracts" set forth in section 413(c)(2) of the Tax Reform Act would not be changed.

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

COMMENTS ON §§1810(f)(4)(A) and 311(b)(4) OF THE TAX REFORM ACT OF 1986

Withholding by Partnerships on Dispositions of United States Real Property Interests - Code Section 1445(e)(1)

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

The comments were prepared by members of the Real Estate Tax Problems Committee. The report was written by Michael Hirschfeld of the Real Estate Tax Problems Committee with comments from Nina Krauthamer of the Committee on U.S. Activities of Foreigners and Tax Treaties. The comments were reviewed by James Halpern of the Committee on Government Submissions.

Background: The Tax Reform Act of 1986 amended Section 1445(e)(1) of the Internal Revenue Code to provide that in the case of a disposition of a United States real property interest by a domestic partnership, trust or estate, that entity must withhold tax equal to 34 percent of the gain which is allocable to a foreign partner or beneficiary (or grantor in the case of a grantor trust). Pub. L. No. 99-514, Sections 1810(f)(4)(A), 311(b)(4).

For tax years beginning in 1988 and subsequent years, the tax withheld (which is equal to the maximum corporate rate) will exceed the maximum overall 28 percent rate applicable to individuals. (For tax years beginning in 1987, the maximum individual long-term capital gains rate is 28 percent, and the rate on other income of an individual cannot exceed 38 1/2 percent). We believe it is inappropriate for a tax to be withheld on individuals at a rate which exceeds the maximum overall rate applicable to individuals.

Recommendation: We recommend that Section 1445(e)(1) be amended, effective as of January 1, 1988, to provide for the following rates of withholding:

(a) 34% in the case of a foreign corporation;

(b) 28% in the case of a nonresident alien individual; and

(c) 34% for all other foreign persons, except that a 28% rate shall apply to the extent provided in regulations.

Dated: July 7, 1987

Discussion: In the case of overwithholding under Section 1445(e)(1), the foreign individual partner could, upon filing his tax return (generally by June 15th of the year following the tax year in question), request a refund claim for the amount overwithheld. However, in that event, there may be a significant time delay between the time of withholding and the time of the refund. In addition, interest on that overwithheld amount will generally not be paid except in limited circumstances. Accordingly, the present system amounts to an interest-free loan between the non-corporate foreign investor and the Internal Revenue Service.

There do exist procedures under Section 1445(e) by which a withholding certificate can be requested from the IRS to reduce or eliminate the amount of withholding. However, it is not clear from the Treasury Regulations applicable to withholding whether a withholding certificate can be granted to a partnership to reduce withholding. See Treas. Reg. §1.1445-5(c)(2)(iv) (this subsection provides only for elimination of withholding where a domestic partnership disposes of a United States real property interest; no statement is made as to reduced withholding). Compare Treas. Reg. §1.1445-5(e)(2)(iv) (this subsection, which deals with distributions to foreign persons by U.S. real property holding corporations, specifically provides for both elimination of, or reduction in, withholding through use of a withholding certificate).

Notwithstanding the foregoing, assuming the IRS would accept a request for a withholding certificate to provide for reduced withholding, that request would be made by filing a submission with the IRS in accordance with Rev. Proc. 85-41, which is a burdensome task for both the taxpayer and the IRS. Moreover, if a partnership is selling multiple properties, an investor would have to request multiple withholding certificates unless a blanket withholding certificate was granted under Section 9 of the Revenue Procedure. However, receipt of a blanket withholding certificate necessitates furnishing a letter of credit to the IRS (see Section 9.01), which makes that option not feasible.

We believe the resources of the IRS are better used in other areas of international taxation, rather than responding to withholding certificates in an area that could otherwise be handled by the suggested legislative change. We also believe that the current situation has adverse effects in the international community and its view of our tax laws. With a basic withholding rate on passive investment income (that is, fixed or determinable annual or periodical income, such as dividends and interest) of 30 percent whereas the actual maximum individual income tax rate is 28 percent (effective 1988), there is already a strain in this area that is further aggravated by this FIRPTA anomaly.

We recognize that there may be some concern as to how a partnership is to identify non-corporate foreign investors. For that reason, we have limited our recommendation to having a 28 percent rate for individuals, and a 28 percent rate for other non-corporate investors only where provided in regulations. Our assumption is that it will be simple for a partnership to identify which investors are individuals or, if deemed warranted, have the IRS amend its existing forms to corroborate that fact or add an appropriate certification as to individual status. However, it may be difficult for a partnership to determine whether a non-individual investor is a corporation, partnership, trust or estate for U.S. tax purposes. Therefore, withholding should not be reduced for that category of non-individual investors unless adequate safeguards, in the IRS's view, are adopted to insure that the investor is not a corporation. In this regard, we recognize that this may be difficult absent receipt of an IRS ruling as to the tax classification of the entity. However, concern about the tax status of foreign entity investors should not be the cause for penalizing foreign individual investors.

While concern may also be expressed that an individual may hold a partnership interest as a nominee for a corporate investor and thereby produce a potential revenue loss to the Treasury, we believe that changes made by the 1986 Act affecting nominees already make that possibility remote and should not be the reason for not allowing relief in this area. In particular, Section 6031(c), Nominee Reporting, was added to the Code by the 1986 Act so as to specifically require nominees holding partnership interests to disclose that fact to the partnership and disclose to the partnership the name, address and "any other information for such taxable year as the Secretary may by form and regulation prescribe." That section should offer sufficient safeguards to any concerns about abuses involving nominees.

Lastly, we believe that since this proposed change will only conform the withholding tax to the maximum tax liability, it should be revenue neutral. Therefore, there should be no objection to this proposal from a revenue perspective.

DATE: July 17, 1987

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

COMMENTS ON H.R. 2636 AND S. 1350

(AS INTRODUCED ON JUNE 10, 1987 IN THE HOUSE AND SENATE)

TECHNICAL CORRECTIONS BILL OF 1987

Real Estate Provisions Relating to

Rehabilitation and Low-Income Rental Housing Tax Credits

Sections 42, 46, 48 and 469 of the Code

Sections 102(k) AND 102(l) of the

Technical Corrections Bill of 1987

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or its Section of Taxation.

This report was prepared by members of the Committee on Real Estate Tax Problems with the assistance of the Committee on Low-income Taxpayer Problems Committee. The member of the Committee on Real Estate Tax Problems primarily responsible for the comments was Arnold B. Kogan. Additional comments were received from: Frederick L. Ballard, Jr., William F. Delvac, Richard S. Goldstein, Michael Hirschfeld and Nina Krauthamer. The comments were reviewed by John Harper of the Committee on Government Submissions.

This position paper includes both comments on the language set forth in the Technical Corrections Bill of 1987 [hereinafter "Bill"] as well as suggestions for inclusion in the bill. References are to the pages in the Bill or the Description of the Technical Corrections Bill of 1987 prepared by the Staff of the Joint Committee on Taxation (June 15, 1987) [hereinafter "Description"].

REHABILITATION TAX CREDIT

1. Transition Rules:

a. Bill - section 102(k)(1), p. 51, lines 11-14, follows through with the suggestion in the General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation (May 4, 1987) [hereinafter "General Explanation"], note 40 at page 151, in clarifying the transition rules apply to projects on which Parts I and II of the Historic Certification Application were filed by March 1, 1986 or the lesser of 5% or $1,000,000 of the rehabilitation expenditures were incurred by that date even though there was no written rehabilitation contract by that date. (There still is the requirement that the building be under a pre-existing binding acquisition contract). This amendment appropriately removes the repetitive language which created the confusion. The commenting members agree with this provision.

b. The Description on page 15 indicates that a provision was included in the capital recovery section of the Bill to clarify that the property eligible for the 25-percent tax credit under the transition rules is not subject to a full basis reduction. This was suggested by the General Explanation, note 41 at page 151. This provision would be an override of section 251(c) of the Tax Reform Act of 1986 which provides for a full basis reduction after 1986. The commenting members agree with this provision.

2. Leasehold Provision (new):

There are several issues with respect to eligibility of lessees for the rehabilitation tax credit that should be addressed: (1) the provision that a tenant's rehabilitation expenditures are qualified rehabilitation expenditures only if, at the end of the rehabilitation, the length of the remaining lease term is at least as long as the recovery period of the property; (2) the applicability of the transitional rules to transfers of leasehold interests; (3) the operation of the rental real estate exception in section 469(i) to the limitation of passive losses and credits; and (4) the interaction of investment tax credit pass through rules and the limitation on passive losses and credits.

a. Lease Term for Tenant Rehabilitation Projects (new)

The Tax Reform Act of 1986 (the "1986 Act") retained the provision that a lessee's expenditures are qualified rehabilitation expenditures if, on the date the rehabilitation is completed, the remaining term of the lease is not less than the recovery period of the property determined under section 168(c). See Code section 48(g)(2)(B)(vi). A similar provision was added by the Economic Recovery Tax Act of 1981 which provided that the lease term remaining at the end of the rehabilitation must be not less than fifteen years. As the recovery period for real property was increased first to eighteen and then nineteen years, the provision in Code section 48(g) regarding lessee rehabilitations was amended accordingly.

The length of lease term provision was almost certainly intended as an anti-abuse measure. Before the 1986 Act, a lessee could amortize leasehold improvements over the lease term if the lease term was shorter than the recovery period of real property; or a lessee could depreciate such improvements over the recovery period of the property if the lease term was longer than the recovery period of the property. Therefore, the potential for abuse existed in that a tenant with a very short lease term could both earn a rehabilitation tax credit and amortize the remaining basis in such improvements over a very short period.

The 1986 Act changed the rules with respect to amortization of leasehold improvements. Now, lessees can only recover costs of leasehold improvements over the recovery period of the property. General Explanation, page 108. Upon termination of the lease, a lessee who does not retain the improvements must compute gain or loss by reference to the adjusted basis of the improvements at that time. As a result of this change made by the 1986 Act, there no longer appears to be a need to require that the lease term remaining at the end of the rehabilitation be as long as the recovery period of the property. Furthermore, the 1986 Act extended the recovery period of real property to 27.5 years for residential real property and 31.5 years for non-residential real property. It is commercially impractical to require a 31.5 year lease after rehabilitation in order for a lessee to be eligible for a rehabilitation tax credit. Consequently, the usefulness of a provision allowing lessees to earn a rehabilitation tax credit may be entirely vitiated.

b. Transfers of Leasehold Interests (new)

The General Explanation indicates at page 151 that if a taxpayer transfers his rights in property under rehabilitation or under a binding contract to another taxpayer, the modifications made by the 1986 Act do not apply to the property in the hands of the transferee as long as the property was not placed in service before the transfer by the transferor. This provision should be clarified with regard to what transfers qualify for transition relief. Specifically, is the transfer of a leasehold interest a transfer which qualifies for transitional relief, i.e. is a lessee "grandfathered" to the extent the lessor is grandfathered? For example, would this apply to a section 708(b)(1)(B) deemed termination-reformation of a partnership?

c. Rental Real Estate Exception to the Passive Loss Limitation (new)

Code section 469(i) provides an exception for rental real estate activities to the general limitation on losses and credits from passive activities. There are two special rules which were intended to provide a somewhat more favorable exception for rehabilitation projects. First, in the case of low-income housing or rehabilitation credits there is no participation requirement. Code section 469(i)(6)(B). Second, for such projects the phase out of the $25,000 rental real estate exemption begins at $200,000 of adjusted gross income rather than $100,000. Code section 469(i)(3)(B). The effect of including the more favorable exception for rehabilitation credits within the rental real estate exception is to deny such favorable treatment where a rehabilitation credit project is not rental real estate. For example, the General Explanation at page 249 indicates that hotels do not constitute a rental activity under the passive loss rules. Therefore, a taxpayer would have to materially participate in a hotel rehabilitation project to be able to use the rehabilitation tax credit against tax on other than passive income.

To rectify this, the rehabilitation tax credit exception to the passive loss rules should be changed to provide that to the extent a rehabilitation credit activity is a passive activity, an exception similar to the provisions of Code section 469(i) with respect to rehabilitation credits shall apply.

d. Interaction of Lessor Pass Through of Credit and Passive Loss Rules (new)

Code section 48(d) provides that a lessor of property may elect to "pass-through" the investment tax credit to the lessee. In the case of a rehabilitation credit earned in a rental real estate activity, the question arises whether the rehabilitation credit which is passive with respect to the landlord retains such character if it is passed through to tenants. A landlord in a rental real estate activity is considered passive per se with respect to that activity. However, a tenant is probably actively engaged in a trade or business. Therefore, if the landlord elects to pass through the credit tenants should be allowed to use the credit to offset active income with the credit.

3. At-risk Limitations (new)

The commenting members also suggest a provision be included in the Bill to conform the "at-risk" exception provisions contained in section 46(c)(8) of the Code to the at-risk exception provisions contained in section 465(b)(6) of the Code.

The Tax Reform Act of 1986 extend the "at-risk" rules contained in section 465 of the Code to real estate activities. However, in the case of real estate activities, an exception is provided for "qualified non-recourse financing" in section 465(b)(6). This exception is similar to but more liberal than the exception provided for "qualified commercial financing" under the investment tax credit "at-risk" provisions contained in section 46(c)(8) of the Code.

Prior to the 1986 Act, the investment tax credit "at-risk" limitations contained in section 46(c)(8) did not apply to the rehabilitation tax credit, because section 46(c)(8) limitations applied only to those "at-risk" activities under section 465. Since real estate activities are now at-risk" activities under section 465, the rehabilitation tax credit is subject to the limitations imposed under section 46(c)(8). As stated above, section 46(c)(8) provisions are significantly more restrictive than section 465(b)(6) provisions, For example, unlike section 465(b)(6) provisions, section 46(c)(8) provisions limit the amount of nonrecourse financing to 80% of the investment and do not permit related party financing.

The "at-risk" rules relating to real estate activities and the rehabilitation tax credit should be the same, and there appears no justification for the distinction. Therefore the definition of qualified nonrecourse financing contained in section 465(b)(6)(B) should be extended to the rehabilitation credit, as well. This could be accomplished by incorporating the exception for commercially reasonable financing from related parties appearing in section 465(b)(6)(D)(ii) in section 46(c)(8)(D)(iv). This amendment should also allow nonrecourse financing from a redevelopment authority or other governmental body that sold the property to the taxpayer - at least where there is an open developer selection process.

LOW-INCOME HOUSING TAX CREDIT

1. Code Section 42 Comments

a. Delay Due to Unforeseen Circumstances

Section 102(1)(17)(A) of the Bill amends section 42(h)(6)(B) of the Code as added by the Tax Reform Act of 1986 by adding provisions to allow an allocation for any calendar year to be carried forward to a succeeding calendar year if it was reasonable to believe that the building would be placed in service during the earlier calendar year but the building was not in fact placed in service and this failure was "solely because of unforeseen conditions which, as determined by the Secretary, were not within the control of the taxpayer." The Bill or at least the committee reports should indicate that reasons for delays in the time of performance of the type excused from damages in standard construction contracts (AIA General Conditions of the Contract for Construction, Document A201, Paragraph 8.3.1) such as "labor disputes, fire, unusual delays in transportation, adverse weather conditions not reasonably anticipatable, unavoidable casualties" are within the scope of the exception. Other delays could be from the inability to obtain in a timely fashion the necessary governmental approvals such as zoning and environmental permits. Often these delays occur in smaller communities because of the unavailability of key government employees or the absence of a quorum of members of a administrative or legislative body.

A further safe harbor rule should be added to to provide that where fifty percent (50%) of the total building costs have been expended and the project is actually placed in service no later than the end of the year following the year of the original allocation the credit allocation would be retained by the project.

The Bill in section 102(1)(17)(A), lines 11-14, requires a determination by the Secretary, implying that a private ruling is necessary in every case. This creates a situation similar to the period when the Tax Reform Act of 1986 was being considered and investors withdrew from the real estate market because of the uncertainty. To add the risk of a total loss of the credit to the investors because of a delay in construction or otherwise, seems unreasonable. The interests of the states in preserving and marshalling the tax credit as a state-awarded economic benefit will adequately protect the Federal government against improvident allocations.

b. Rent Skewing and Requirements Conflict (new)

Section 102(1)(13) of the Bill amends section 42(g)(4) of the Code with respect to deep rent skewed projects which elect to rent 15% of the units to tenants whose incomes are 40% or less of area median. The Bill provides that for purposes of meeting the 30% rent limitation, "gross rent" does not include federal rental assistance payments. However, the Bill does not change the rule that for purposes of meeting the requirement that the rent on low-income units not exceed one-third of the average rent with respect to comparable non-low income units, "gross rent" shall include federal rental assistance payments. This makes the deep rent skewed option unworkable. For tax-exempt bond financed deep rent skewed projects, this further complicates the already existing conflict between section 42(g)(4) and section 142(d)(4) which provides that federal rental assistance payments are included in "gross rent" for all purposes, including the 30% rent limitation. These conflicts should be resolved in a manner that would not include federal subsidies in the rent for the computation of the 30% rent limitation.

c. Multi-building Projects (new)

The Technical Corrections Bill fails to address a problem with respect to allocations. Section 42(h) provides that allocations can be made on a project-wide basis, but become effective on a building-by-building basis as buildings are placed in service. This creates needless confusion in cases where all the buildings in a multi-building project are placed in service at or about the same time. The allocations should become effective on a project-wide basis if all buildings comprising a project go into service in the same taxable year.

d. Placement in Service - Eligible Basis (new)

Code section 42(d)(5)(A) as added by the Tax Reform Act of 1986 provides the eligible basis for computing the credit is determined as of the date the property is placed in service. Apartment projects are almost alway staged whereby different sections, wings, floors are placed in service at different times. Further outside work such as landscaping, repointing, painting and paving may be delayed because of weather conditions. If the date the first unit is placed in service determines the eligible basis, substantial inequity results by eliminating otherwise qualified later expenditures. The Code should be amended to provide that the eligible basis is determined at the same time that the project's qualified basis is determined under section 42(f)(1) of the Code. This later determination takes place on the last day of the taxable year in which the project is placed in service, or if the taxpayer elects, on the last day of the succeeding year. A common date for determining both bases simplifies administration of these provisions.

e. Purchase of Partnership Interests (new)

The Code section 42(d)(2)(B)(i) in requiring the acquisition of a building by purchase. This prevents utilization of the credit where taxpayers acquire all of the partnership interests of the owning entity rather than the building itself. There are legitimate business reasons for the purchase of partnership interests rather than a building such as an assumption of unsecured liabilities or transfer of nonreal estate assets in a bulk sale. The above provision should therefore be amended to provide that the acquisition of ninety percent (90%) or more of the partnership interests is treated the same as a direct acquisition of the building.

2. Inflation Adjustment (new)

The passive loss limitations of Code section 469 are applicable to the low-income credit. While Code section 469(i) provides for an exception to the passive loss rules that allows for use of a certain dollar amount of credits to offset non-passive income, that exception is generally phased-out once a taxpayer's adjusted gross income exceeds $200,000. Section 469(i)(3)(B).

The commenting members express concern that since the low-income credit is allowable over a ten year period, there should be some mechanism to provide for adjusting the $200,000 threshold over that ten year time period to take into account changes in income that arise by economic factors beyond the control of the taxpayer. For example, an individual who receives a cost-of-living adjustment to his salary could easily find that during that ten year period, the $200,000 threshold will be exceeded. In this situation, the investor's actual economic income has not increased but the $200,000 threshold does not take that into account. Accordingly, the commenting members recommend that there be included a mechanism for adjusting the $200,000 threshold for inflation.

The suggested statutory language would be to add a new subsection (E) of Code section 469(i)(3), that will read as follows:

(E) ADJUSTMENT FOR INFLATION - In the case of an taxable year beginning in a calendar year after 1987, the dollar amount

contained in section 469(i)(3)(B) shall be increased by an amount equal to--

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins.

This change would be consistent with the inflation adjustment applicable to:

(1) The individual income tax tables, as set forth in section 1(f),

(2) The standard deduction, as set forth in section 63(c)(4),

(3) The personal exemption amounts, as set forth in section 151(d)(3), and

(4) The exception from the below market interest rules for certain loans to qualified continuing care facilities, as set forth in section

7872(g)(5).

3. At-risk Rules

The comments under relating to the at-risk rules apply also to the low-income housing tax credits; so the suggested change should also be applicable to the rehabilitation tax credit (Section 3 under REHABILITATION TAX CREDIT) are applicable to the low-income housing credit. In urban renewal areas and in particular with respect to low-income housing, buildings and land are often acquired from and financed by nonprofit and governmental sellers. This financing by a seller (who also may become a joint venturer) should be permitted and encouraged without restriction as the Internal Revenue Service already grants deference to below-market interest financing by governmental bodies under section 7872. See Temporary Treasury Regulation section 1.7872-5T(a)(2).

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

COMMENTS ON SECTION 108(f) OF H.R. 2636 THE TECHNICAL CORRECTIONS BILL OF 1987

Amendments to Section 453C Regarding Certain Indebtedness Treated as Payment on Installment Obligations

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The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

The comments were prepared by members of the Real Estate Tax Problems Committee. Members of the Committee who submitted comments were Kelly E. Bunch, Michael Cook and Michael Hirschfeld.

The comments were reviewed by John S. Harper of the Committee on Government Submissions.

Dated: July 13, 1987.

The following is our comments on Section 108(f) of the Technical Corrections Bill of 1987 (the "Bill") regarding the proportionate disallowance rule for installment sales under Section 453C. This submission also proposes additional changes to Section 453C, which we believe would be beneficial to incorporate in the Bill.

I. Comments Regarding the Bill

A. Casual Sales

Section 108(f)(1) of the Bill would amend Section 453C(b)(4) to provide that the determination of AII is computed as of the close of the taxpayer's taxable year in lieu of using the taxpayer's average installment indebtedness if the taxpayer has no applicable installment obligations outstanding as of the close of his taxable year. As it presently reads, the statute would compute AII at the close of the taxpayer's taxable year only if the taxpayer did not at any time during the taxable year have outstanding installment obligations attributable to the sale of dealer real or personal property after February 28, 1986.

Comment. The change is commendable as it enables potentially more taxpayers to use the rule and allows greater flexibility to taxpayers by determining the existence of disqualifying installment obligations on a specified date which is determinable in advance.

Recommendation. We recommend that Section 108(f)(1) be enacted.

B. Tacking of AIOs

Section 108(f)(3) of the Bill would amend the Section 453C(e)(1) definition of AIOs to include installment obligations which are held by a transferee who has a carryover basis in the installment obligation and which were AIOs in the hands of the transferor.

Comment. The expansion of the definition of AIO appears to be reasonable in order to limit the ability of taxpayers to avoid application of Section 453C through transfers, such as involving a partnership non-liquidating distribution of an AIO to one of its partners. However, the transfer of an AIO should not result in cumulative deemed payments to its holders in excess of its face amount. This would necessitate tracing an AIO through the chain of its holders in order to take into account the amounts previously included as a deemed payment on a holder's AII by reason of its inclusion in their AIO computation.

Recommendation. We recommend that the Bill amend the statute to provide that where a taxpayer acquires an AIO with a carryover basis, the amount of the deemed payment with respect to his AII attributable to such AIO cannot exceed the face amount of the AIO less any deemed payments attributable to such AIO on the AII of its previous holders.

II. Additional Comments Regarding Section 453C

A. Defining Taxpayer Indebtedness - Wraparound Mortgages.

Issue. The use of a wraparound mortgage may produce an unintended result, which is not supported by the taxpayer's economic position. Assume, for example, that a taxpayer owns one asset, an apartment building with a basis of $50x and fair market value of $100x, which secures debt of $40x. If the taxpayer sells the building in a transaction whereby the buyer assumes the $40x debt and gives a second mortgage of $60x for the balance of the consideration, the taxpayer will receive the full benefit of installment reporting because he has no indebtedness. But, if instead the buyer gives a wraparound second mortgage note for $100x, the taxpayer will have applicable installment obligations ("AIO") of $100x and indebtedness of $40x and the resulting formula for calculating the allocable installment indebtedness ("AII") will be:

$$\frac{\$100x\ (\text{AIO})}{\$100x\ (\text{AII Assets})} \times \$40x\ (\text{indebtedness}) = \$40x\ (\text{AII})$$

Discussion. For purposes of determining debt assumed in excess of basis (which constitutes a payment under the installment sale rules), in the case of a wraparound note, temporary regulations (Temp. Treas. Reg. 15a.453-1(b)(3)(ii)) provide that the underlying debt is treated for tax purposes as though assumed, even though the contractual terms between a selling taxpayer and a buyer normally negate an assumption of the underlying debt by the buyer. For purposes of the proportionate disallowance rule, the results of the two transactions described above should not be different since the economic consequences are the same. The difference in treatment occurs with respect to the wraparound mortgage situation because the underlying debt is not removed from the taxpayer's balance sheet since it is not assumed as a part of the consideration tendered by the buyer.

Recommendation. The Bill should specify that the taxpayer's underlying debt in a wraparound mortgage situation is not treated as indebtedness of the taxpayer for purposes of computing AII under Section 453C.

B. Defining Taxpayer Indebtedness - Nominal Amount of Personal Debt

Issue: For purposes of computing a taxpayer's AII, a taxpayer must consider all his outstanding debt except for "indebtedness with respect to which substantially all of the property securing such indebtedness is [personal use property]." IRC, §453C(b)(3)(B). This would require a taxpayer to include indebtedness such as that from credit cards no matter how nominal. This may also cause certain taxpayers to be subject to these rules even though their debt is quite nominal in amount.

Recommendation: To ease the compliance difficulties evident in these rules and the potential unfairness that may result to certain taxpayers from application of these rules, we would recommend that a nominal amount of personal debt (such as $10,000) be excluded from the computation or, at a minimum, the IRS be given the regulatory power to exclude a certain portion of debt from the computation.

C. Computation of AII with Respect to Pass-Through Entities.

Section 453C(e)(5)(A) specifically authorizes regulations to disallow installment reporting "in whole or in part for transactions in which the rules of this section otherwise would be avoided through the use of related parties, pass-through entities, or intermediaries."

The Conference Committee Report expands on this provision and states in part as follows:

> "The conferees intend that these regulations may aggregate the assets of the related parties for purposes of applying the proportionate disallowance rule. For example, the conferees intend that such regulations may aggregate the assets and indebtedness of a partnership and each of its partners in determining the extent to which each such partner may report gain arising from the installment sale of partnership assets on the installment method." Page II-299.

(1) Aggregation at Partnership or S Corporation Level.

Issue. The above-quoted Conference Committee Report speaks of aggregating assets and liabilities without reference to the statutory language which implies that the aggregation is to be done only in factual patterns involving avoidance so that an automatic recasting of assets and liabilities does not occur in every pass-through entity situation. Furthermore, while the imposition of the aggregate theory for purposes of Section 453C may make sense from a conceptual standpoint, administratively, it will be difficult, if not impossible, to execute in practice even if limited to appropriate avoidance situations. Thus, the issue here is how to identify avoidance situations and accomplish the aggregation of the assets and indebtedness of a pass-through entity in such situations.

Discussion. Strict application of the aggregate theory can produce an unintended result. For example, assume that a partnership with no debt makes an installment sale. The partnership has two partners, one of whom has no debt and the other who is heavily leveraged. If strict aggregation is applied, the partner with no debt will have AII because the debt of the other partner is included in the computation at the partnership level, a result that is patently unfair. It is not clear why an aggregation at the S corporation or partnership level should be necessary since the Section 453C AII computation should be made at two levels for purposes of installment reporting. A selling S corporation or partnership should first use only its own assets and liabilities to make the test at the corporate or partnership level and then each shareholder or partner should use the allocated installment sale (subject to S corporation or partnership AII) to recompute AII at the shareholder or partner level. The double procedure protects the shareholder or partner who has no or nominal indebtedness.

Recommendation. We recommend that the Bill specify that the Section 453C AII computation requires computation first at the S corporation or partnership level (without consideration of shareholder or partner debt or assets), and then recomputation at the shareholder or partner level. We also recommend that the Bill provide some means for adjustment where there exists underlying indebtedness between the entity and the owner. For example, where a shareholder (or partner) contributes funds to an S corporation (or partnership) as debt, consideration should be given to treating that amount as equity rather than debt for purposes of these rules. See, for example, LTR 8620051, Feb. 19, 1986 (the IRS ruled that a partnership did not own debt-financed property (within the meaning of Code Section 514) whose income would thereby constitute unrelated business income to its tax-exempt partners where the debt was owed to the partners of the partnership).

We further recommend that the statute specifically eliminate the possiblity of applying aggregation to certain specified non-avoidance situations. In particular, the statute could provide a safe harbor to shareholders in S corporations and partners in partnerships who own a 5% or less interest in such entity, where the entity is not "closely held." In this situation, the lack of control in a non-closely held entity would appear to indicate that there is no avoidance motive on the part of that shareholder or partner. For these purposes, the term "closely-held" could be defined in a manner similar to the term as used in the transitional rules of Section 633(d)(5)(A) of the Tax Reform Act of 1986 regarding qualified closely held corporations and the attribution rules for determining ownership of such corporations. Under those rules, a closely held S corporation or partnership would be one in which more than 50% (by value) of the interest in such entity is held by ten or fewer persons (or entities). Attribution, for purposes of these rules, would be applied similar to the attribution rules provided for in Section 633(d)(6)(C) of the 1986 Act, as proposed in Section 106(g)(5)(B) of the Bill.

(2) Computation of Partnership Interest.

Issue. If a partner making an installment sale is required to include a portion of the partnership's indebtedness, which is determined by multiplying the partner's partnership percentage interest by partnership indebtedness on the date of the relevant debt determination, what will be considered the partner's percentage interest for purposes of Section 453C?

Discussion. There does not appear to be any method of determining a partner's percentage interest that fits the policy underlying Section 453C. If the purpose is to tax the proportionate gain on the cash receipts of a sale and cash receipts include cash generated by borrowing, the fairest method would be to trace the ultimate distribution or use of borrowed funds. In most cases, the debt will represent borrowings prior to the installment sale and it most likely will have been used for an investment at the pass-through entity level, and in such case the capital interest as opposed to the profit and loss allocation interest may more closely fit the purpose of Section 453C. But, administratively, it will usually be difficult, if not impossible, to determine the capital interest, except in the most basic form of partnership. On the other hand, the income and loss allocation percentage is more easily determined and more closely relates to the tax attributes of debt, i.e., interest deductions, cost recovery resulting from the asset purchased by debt, or deductible expenses paid for with debt.

Recommendation. We suggest that the Section 453C regulations use a partnership percentage interest that is easy to determine. Therefore, we recommend that the partnership percentage interest be determined by the partnership allocation percentage in accordance with the rules of Section 752. Thus, a partner's portion of the partnership's indebtedness will be determined by reference to such partner's profit allocation percentage in the case of nonrecourse debt and by reference to such partner's loss allocation percentage in the case of recourse debt.

(3) Sale of an Interest in a Pass-Through Entity.

Issue. If a taxpayer sells an interest in a pass-through entity on the installment basis, will the entity theory be recognized for determining the asset sold and thus application of the proportionate disallowance rule? For example, if 50% of partnership assets are realty (by some measure such as by basis or fair market value), will the proportionate disallowance rule then apply to 50% of the gain?

Discussion. With respect to the aggregate versus entity issue, the 1984 Tax Reform Act Blue Book adopted a "look through" position with respect to Section 453(i) in dealing with the immediate reporting of recapture of cost recovery on partnership assets when a partnership interest is sold on the installment basis. That position is easy to administer. However, to break up a partnership's assets for purposes of applying recently enacted Section 453C will create administrative difficulties that would offset any benefit to the aggregate approach.

A similar problem exists under Section 897(g), which directs the issuance of regulations to determine the extent to which gain from the sale of a partnership interest is attributable to United States real property interests and so subject to tax under FIRPTA and withholding. In the seven years from the 1980 enactment of FIRPTA, no regulations have been issued on this point, which is probably indicative of the difficulty of devising a means to calculate such gain. Thus, there is no guidance for taxpayers presently available, even through use of analogy to other Code Sections.

Another concern is the means by which apportionment should be effected. In other words, should the apportionment between AII assets and non-AII assets be based upon original cost, adjusted basis for tax purposes or fair market value?

Recommendation. We believe the foregoing comments illustrate the difficulties inherent in the automatic aggregation of individual assets and debts into pass-through entity computations and disaggregation of entity assets and debts into individual sales. We therefore recommend adoption of the 5% safe harbor set forth in II(C)(1) to sales of an interest in a pass-through entity so that installment sales of such interests will not be subject to the proportionate disallowance rule. In this situation, we view the lack of control as evidencing a non-avoidance situation. While proof of an avoidance motive could still be offered, we view it as appropriate to eliminate consideration of such factors for these investors in view of their lack of control and the corresponding difficulty in compliance and enforcement.

With respect to sales that are otherwise appropriate to cover by regulations, we recommend that the Bill should clarify that the regulations should be prospective only. We believe retention of the broad avoidance approach is appropriate but suggest that the accompanying legislative history delineate appropriate avoidance situations. Examples of situations evidencing an avoidance purpose would include the contribution of property subject to debt by a partner who sells on an installment basis, or the incurrence of debt by a partnership in temporal conjunction with the installment sale and a distribution to the partners, in cases where the partner may have personal liability with respect to the partnership debt.

D. Definition of Property Held For The Production of Rental Income.

(1) Nominal Rents.

Issue. If unimproved real property that is held primarily for investment is leased for nominal payments to a farmer to preserve favorable local real property tax rates, will an installment sale of the property be subject to the proportionate disallowance rule?

Discussion. Section 453C(e)(1)(A)(III) applies the proportionate disallowance rule to real property used in the taxpayer's trade or business or held for the production of rental income. In the example above, the taxpayer does receive rental income, but the nominal amount would indicate the taxpayer is not holding the real property for the production of rental income but for investment purposes. The receipt of rental income is incidental to the investment purpose of achieving long-term appreciation. This provision should be construed to mean that the production of rental income must be the primary motivation for the investment by the taxpayer.

Recommendation. We recommend that the Bill give the IRS regulatory authority to establish safe harbor criteria for determining nominal rent exclusions.

(2) Farming Partnerships and Sharecropping Arrangements.

Issue. Will the exception under Section 453C(e)(1)(B)(ii) be recognized in farming partnerships and sharecropping arrangements?

Discussion. The partnership and sharecropping arrangements present different considerations. If the partnership is the seller under the installment method and the land is used in the farming business, the property is being used in a trade or business, but it is also "property... used in the trade or business of farming" and the exception under Section 453C(e)(1)(B)(ii) should apply. The same result should apply with respect to the sharecropping arrangement. However, the application of the farming property exception to the facts in the two arrangements may turn on whether factual patterns are more like rental arrangements to the landowner.

Our concern in this area is primarily inspired by the passive loss limitation provision of the 1986 Tax Reform Act. Typically, a partnership or sharecropping arrangement between the landowner and a farmer requires very little participation by the landowner and certainly, the landowner would rarely pass the material participation test of Section 469.

Recommendation. We recommend that the Bill be amended to clarify that the issue of whether land is used in the trade or business of farming does not depend on the activities of the partners or the parties to the sharecropping arrangement. On the other hand, the Bill should preclude a land owner from using the farming property exception where partnerships or sharecropping arrangements are in reality disguised rental arrangements. The test should look to the substance of the arrangement so that where a landowner receives cash distributions regardless of whether the enterprise produces net profits, the arrangement should probably be considered a rental arrangement.

SECTION OF TAXATION AND AMERICAN BAR ASSOCIATION COMMENTS ON THE PROVISIONS OF THE TECHNICAL CORRECTIONS ACT OF 1987 CONCERNING REGULATED INVESTMENT COMPANIES

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the overall view of the American Bar Association or of the Section of Taxation.

The comments were prepared by members of the Regulated Investment Companies' Committee. Members of the Committee who submitted the comments were: Susan A. Johnston, Chair, Richard M. Hervey, Vice-Chair, Thomas A. Humphreys, Last Retiring Chair, Steven D. Conlon, John A. Koltes, Stephen B. Land, Theodore L. Press, Brett A. Robbbins, and Sharp Sorensen. The comments were reviewed by John S. Harper of the committee on Government Submissions.

Dated: July 16, 1987

COMMENTS ON H.R. 2636 AND S.1350 TECHNICAL CORRECTIONS ACT OF 1987

These comments address the specific provisions (Sections 106(l)-(o)) of the Technical Corrections Act of 1987 (the "Bill") as introduced in the House and Senate relating to the regulated investment company ("RIC") provisions of the Code (Sections 851-855 and 4982), and suggest certain other technical corrections relating to those RIC provisions.

I. Comments Relating To The Excise Tax Under Section 4982

A. Background

Effective for calendar years beginning after December 31, 1986, Section 651 of 1986 Act added Section 4982 of the Code which imposes for any calendar year a nondeductible excise tax on any RIC equal to 4% of the excess, if any, of the "required distribution" for the calendar year ending within the taxable year of the RIC, over the "distributed amount" for such calendar year.

For these purposes, the term "required distribution" generally means, with respect to any calendar year, the sum of (i) 97% of the RIC's "ordinary income" for such calendar year, (ii) 90% of the RIC's capital gains (both long-term and short-term) from the sales or exchanges of capital assets over the losses from such sales or exchanges for the one-year period ending on October 31 of such calendar year and (iii) undistributed amounts from previous years based on the preceding calculations. Section 4982 was enacted to prevent a deferral of income to RIC shareholders through the use of non-calendar fiscal years for RICs, or the payment of "spillover" (or "sweep-out") dividends by the RIC under Section 855.

The lower distribution requirement for capital gains, and the measurement of such gains during the period ending on October 31, is based on the inability of RICs to determine accurately capital gain income within a sufficient time prior to the end of the calendar year to enable the timely declaration of a dividend. Unlike income from interest or dividends, which is generally predictable, capital gains and losses cannot be predicted since the timing and amount of such gains are dependent on market conditions and investment strategy, which will vary over time. Capital gains or losses are also affected by various rules under the Code, such as those relating to wash sales and straddles and the "marking to market" of gains under Section 1256, which further complicates the determination of capital gain income.

B. Discussion

1) Treatment of Ordinary Income Arising From the Sale of Assets

Various provisions of the Code prescribe ordinary income treatment (rather than capital gain treatment) with respect to all or a portion of the gain on the sale of assets which would normally be classified as capital assets. For example, Section 1276 provides for ordinary income treatment on the disposition of market discount bonds.[1] Under current law, such ordinary income arising on the sale of an asset would be included with other ordinary income in computing the required distribution under Section 4982. As a result, sales of assets in the end of the calendar year could cause a RIC to be liable for the 4% excise tax.

We believe that all items of ordinary income which arise on the sale of capital assets should be treated as capital gains for purposes of the excise tax under Section 4982. The unpredictability of such income may well cause a RIC to be liable for the 4% excise tax, even in cases where it distributes all its reasonably determinable ordinary income by calendar year end. The timing and amount of such ordinary income arising from the sale of capital assets is unpredictable just as capital gains on the sale of such assets are unpredictable: If market conditions require the sale of capital assets at the end of December, it would be unreasonable to impose an excise tax merely because part of the gain on the capital asset is reclassified as ordinary income under another section of the Code.

In addition, we believe that all foreign currency gains (whether or not realized upon the sale of a capital asset) should be treated as capital gains for purposes of Section 4982. If, for example, a RIC invests in a debt instrument denominated in a foreign currency, it would realize an unpredictable amount of foreign currency gains on the payment of interest. We believe that the treatment of such foreign currency gains as capital gains for purposes of Section 4982 would be consistent with the apparent purpose of the excise tax of requiring a RIC to distribute essentially all its reasonably determinable income and gains, during the calendar year in which they arise. Because of the unpredictability of foreign currency gains, such gains are more appropriately treated as capital gains for purposes of Section 4982. Regulations should provide for similar treatment in the case of other instruments with varying interest payments or accruals which cannot be predicted with reasonable accuracy.

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[1] See also Section 988 (treatment of certain foreign currency gains); Section 341 (collapsible corporations); Section 1246 (gain on foreign investment company stock); Section 1248 (gain from stock in certain foreign corporations); Section 1291 (passive foreign investment companies); and Section 751 (treatment of partnerships with unrealized receivables and inventory items ("collapsible partnerships")).

In view of the foregoing, we suggest that the following language be added at the end of Section 4982(e):

> (5) RECLASSIFICATION OF CERTAIN ORDINARY INCOME ITEMS -- For purposes of paragraphs (1) and (2), foreign currency gains under Section 988 and amounts of ordinary income realized on the sale, exchange or disposition of a capital asset (including scheduled principal payments on a debt obligation, and the termination of an obligation (or right) by offsetting, taking or making delivery, by exercise or being exercised, by assignment, or being assigned, by lapse, or otherwise) shall be included in computing capital gain net income (and not ordinary income) without regard to any provision of this title which treats all or a portion of such amount as ordinary income. The Secretary may also by regulation treat other items of ordinary income as capital gain for purposes of this section.

2) Waiver of Excise Tax. We also believe Section 4982 should be amended specifically to provide that the Treasury or Internal Revenue Service has the power to waive liability for the excise tax under Section 4982. Excise tax liability may well arise due to an absence of official guidance, whether by regulation or otherwise, as to the timing and treatment of certain kinds of income or loss arising in a RIC's hands, even where the RIC has made every effort to compute and make the distribution required to avoid any excise tax liability.

The taxation of many investments made by RICs is unusually complex and the computation of tax (and the required distribution under Section 4982) is affected by provisions such as Section 1091 (relating to wash sales), Section 1092 (relating to straddles), Section 1233 (relating to short sales) and Section 1256 (relating to the mark-to-market rules) which can affect the timing of income and losses. Provisions relating to original issue discount, market discount, amortization of premiums and foreign currency transactions can affect the character of income (see above). The Treasury has not issued regulations relating to many of the above provisions.

For example, the Treasury has not issued regulations which define the term "straddle" under Section 1092. RICs also have to compute income prior to the end of their calendar year for purposes of Section 4982 even though the RIC may not receive information necessary to make such a computation until after the end of the calendar year. In addition, although Section 4982 applies in the 1987 calendar year, the IRS has not issued any regulations under 4982 and there are many issues, including those relating to transitional rules, which require guidance. In light of the above circumstances, it is very possible that a RIC could unknowingly incur an excise tax liability under Section 4982 even when it currently distributes all the income and gains during the year of which it is aware.

In situations where there is a deficiency dividend under Section 860, it appears that there would be no liability under the excise tax since income giving rise to an adjustment which results in a deficiency is treated as arising when the dividend is paid. See Section 4982(e)(3). There are cases, however, where the deficiency dividend would not be helpful in avoiding liability under the excise tax. The deficiency dividend procedure is only applicable if there is an "adjustment" as defined in Section 860(d)(1). There are situations where a change in the timing or character of income could result in a change in the amount of the required distributions under 4982 without resulting in an adjustment under Section 860(d)(1). As an example, if short-term capital gain income is treated as ordinary income as the result of an audit, there would be no "adjustment" to investment company taxable income under Section 860(d)(1) since both short-term capital gains and ordinary income are included in computing investment company taxable income. There may also be situations where there is an adjustment resulting in an increase in the income or gains during a calendar year without any increase during the fiscal year of the RIC (e.g., the deferral of a loss under Section 1091 or 1092).

It should also be noted that if a RIC were to incur a liability under the excise tax as the result of an audit, the shareholders at the time of the payment of such excise tax would suffer an economic detriment even though such shareholders may have acquired their shares after the year in which the underdistribution occurred.

There should be a procedure which enables the Treasury or Internal Revenue Service to waive payment of a deficiency in the excise tax where the shortfall in the distribution results from a reasonable error and there was a good faith attempt to make distributions sufficient to avoid any excise tax liability. There is precedent for such a waiver provision in other Sections of the Code (e.g., Section 4974(d) (relating to underdistributions by certain qualified retirement plans); Section 1375(d) (relating to tax on S corporations with undistributed Subchapter C earnings and profits); Section 6659(e) (relating to tax on valuation overstatements); Section 6659A(e) (relating to tax on overstatements of pension liabilities) and Section 6660(e) (relating to valuation understatements for purposes of estate or gift taxes)).

We therefore suggest that Section 4982(f) be added to the Code as follows:

> (f) AUTHORITY TO WAIVE -- The Secretary may waive all or any part of the tax imposed by subsection (a) if it is established to the satisfaction of the Secretary that an excess of the required distributions over the distributed amount was due to reasonable cause and not due to willful neglect.

3) RICs with Tax-Exempt Shareholders.

As discussed above, the purpose of Section 4982 was to prevent a perceived ability to defer the tax of shareholders through the use of a non-calendar fiscal year or distributions made under Section 855. Certain RICs may be limited to shareholders who are either exempt from tax (such as pension trusts) or who will in fact not be liable for any tax (such as the separate accounts of insurance companies). In such a case, requiring the RIC to comply with Section 4982 would serve no purpose and it would create unnecessary administrative expense. We suggest that the following subsection be added at the end of Section 4982:

> (g) RIC WITH TAX-EXEMPT SHAREHOLDERS -- A regulated investment company which can establish to the satisfaction of the Secretary for any taxable year that all of its shareholders are exempt from tax under Subtitle A or would not, if the required distribution had been made, in fact have been liable for any tax, will be exempt from the excise tax imposed by subsection (a) of this section for such taxable year.

II. Comments Relating To Section 851(b)(2).

A. Background

Prior to the 1986 Act, Section 851(b)(2) provided that a corporation would not be considered a RIC for any taxable year unless "at least 90 percent of its gross income is derived from dividends, interest, payments with respect to securities loans . . . and gains from the sale or other disposition of stock or securities" (the "90% income test").

The treatment of income from modern financial instruments such as options, futures and forward contracts, as well as foreign currency gains, was uncertain under the 90% income test. Although many RICs obtained private rulings that various types of options and futures contracts were "securities" for purposes of the 90% income test, other taxpayers could not rely on such rulings.

Section 653(b) of the 1986 Act expanded Section 851(b)(2) to provide that qualifying income for a RIC includes, in addition to the income qualifying under prior law, gains from the sale or other disposition of foreign currencies, and other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies. The 1986 Act also clarified that "securities" was defined for purposes of Section 851(b)(2) by reference to the definition of that term contained in section 2(a)(36) of the Investment Company Act of 1940, as amended (the "1940 Act").

We understand that, based on this expanded definition of qualifying income, a number of funds may have invested in publicly-traded ("master") limited partnerships ("MLPs") in the belief that since such interests constituted "securities" under the 1940 Act, the RIC's distributive share of income therefrom could be viewed as being "derived with respect to [the RIC's] business of investing in . . . securities." Many RICs believed that the income generated by MLP interests would qualify under Section 851(b)(2) without regard to whether the underlying income of the partnership would qualify under the 90% income test if directly earned by the RIC (e.g., rents from real estate or royalties from oil or gas properties). In addition, some RICs owned shares in corporations which became MLP interests when the corporation converted to an MLP.

The General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation (the "Blue Book"), provided the first official indication that the drafters of the 1986 Act might not have considered the effect of the change in Section 851(b)(2) on the income earned by a RIC through an MLP. The Blue Book stated:

> The Act . . . includes in qualifying income certain income derived with respect to the RIC's business of investing in securities. Nevertheless, the Congress did not intend that a RIC's distributive share of income from a partnership interest would be treated as qualifying income derived with respect to the RIC's business of investing in securities without regard to the character of the income derived from the partnership.

The Blue Book also noted that "a technical correction may be necessary" to reflect the intention described in the above statement.

Section 106(n)(1) of the Bill would amend Section 851(b)(2) to provide that the sources of qualifying income for a RIC include:

> dividends, interest, payments with respect to securities loans . . . and gains from the sale or other disposition of stock or securities . . . or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts but not including partnership or trust income) derived with respect to its business of investing in such stocks, securities, or currencies;

(Bill material highlighted.)

The Description of the Technical Corrections Act of 1987 which was prepared by the Staff of the Joint Committee on Taxation (the "Description") states that "the bill clarifies that income derived by the RIC from a partnership or trust is not income that is considered to be derived with respect to the RIC's business of investing in stocks, securities or currencies."

B. Discussion

The amendment made by Section 106(n)(1) of the Bill would cause a RIC's allocable share of all or certain types of partnership and trust income to be treated as nonqualifying ("bad") income under Section 851(b)(2).

The purpose of the 90% income test is "to help ensure that the regulated investment company is essentially engaging in passive investment activities and is not operating as a normal business corporation."[2] A persuasive argument can be made that a RIC's investment in an MLP is just as passive an investment, from the standpoint of Section 851(b)(2) considerations, as a debt or equity investment in a corporation. If a RIC can invest in corporations which engage in activities such as real estate or oil and gas exploration, there is no underlying policy reason to prevent RICs from investing as a limited partner in similar activities through an MLP.[3] The same can be said of RIC investments in a publicly-traded trust.

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[2] See e.g., H.R. Rep. No. 1192, 94th Cong., 2d Sess. 10-11 (1976); General Counsel Memorandum ("GCM") 38994 (May 27, 1983); Blue Book, pp. 375, 377.

[3] If the objection reflected in the proposed amendment is as a result of the proliferation of MLPs under the current tax regime, the treatment of such MLPs should be addressed directly, rather than indirectly (by treating the investments therein as less passive than stock or debt investments in corporations, as is proposed).

We agree, however, that if a RIC's allocable share of income from an MLP were generally treated as qualifying income under Section 851(b)(2), some restrictions might be justified in situations where the RIC was a general partner or where a closely held partnership was formed by RICs in order to avoid the 90% income test. If such an approach were followed, language could be added at the end of Section 851(b)(2) to provide that:

> For purposes of paragraph (2), the Secretary may, by regulation, on a prospective basis, exclude from income qualifying under such paragraph amounts of income derived from investments in partnerships or trusts where the corporation directly or indirectly acts as general partner or otherwise substantially controls such partnership or trust.

We recognize that if a RIC invests in a non-publicly traded partnership or invests in a partnership as a general partner, Congress and the Treasury may properly treat a RIC as though it earned directly any income allocated to it by the partnership, and that as a policy matter the same treatment may apply to an investment in an MLP. Such an approach is consistent with GCM 39207 (March 29, 1984) and Private Letter Ruling ("PLR") 8416018 (January 13, 1984), which hold that a RIC should take into account its distributive share of the individual items of income of a partnership in which it is a partner for purposes of the qualification tests under Section 851.[4] A similar approach may be taken with respect to trust income." See, e.g., LTR 8131049 (May 7, 1981).

The proposed statutory language and description are ambiguous, however, and do not adequately reflect that approach since they could be read to exclude all income derived from partnerships or trusts, even in situations where the underlying partnership income is derived from qualifying items such as dividends, interest and securities gains.[5] Furthermore, "other income" (e.g., gains from options, futures and forward contracts) could never be income qualifying under Section 851(b)(2) when earned through a partnership or trust. Although a RIC could take the position that partnership income derived from such qualifying items should be treated for all tax purposes as dividends, interest, and securities gains as the result of the pass-through treatment of partnership income under Subchapter K of the Code, it is not certain that such a position would prevail since the language describing Section 106(n)(1) of the Bill contained in the Description does not make any distinction based on the character of the underlying income. The language should be drafted to indicate more clearly the intention behind the amendment.

Accordingly, we recommend that the following sentence be added at the end of Section 851(b):

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[4] See Reg. § 1.856-3(g), which adopts the same approach for purposes of the source of income requirements for real estate investment trusts. See also Sections 652(b) and 662(b) of the Code.

We note because an MLP interest is a "security" within the meaning of Section 2(a)(36) of the 1940 Act, the sale or exchange of an MLP interest produces qualifying income under Section 851(b)(2). This treatment is consistent with the entity approach applied to the sale of a partnership interest. See Section 741.

[5] We are assuming that the reference to "trust income" in the proposed amendment does not include income from trusts treated as associations taxable as corporations (which would include many investment companies qualifying as regulated investment companies under Subchapter M).

> For purposes of paragraph (2), an item of partnership or trust income or gain shall have the same source and character in the corporation's hands as it has in the hands of the partnership or trust.[6]

Any changes should be prospective only. In light of the substantial uncertainty concerning the character of income from MLPs prior to the publication of the Blue Book, we also strongly believe that any change in the treatment of a RIC's allocable share of partnership or trust income should not be retroactive, but rather should take effect 90 days after the date of enactment of the Bill.

As noted above, under the current language of Section 851(b)(2), many funds assumed that any income derived from an investment in a partnership or trust would be qualifying income to the extent that the interest in such a partnership or trust was a "security." The Blue Book implied, as noted above, that such investments might be permitted in the absence of a technical correction. It is possible that a retroactive application of any change in the treatment of a RIC's allocable share of partnership or trust income might result in a disqualification of some RICs for pass-through treatment under Subchapter M. Given that the purpose of the restrictions on the amount of short-short gains a RIC can earn in a given year is to regulate the behavior of RICs rather than to raise revenue through disqualification of pass-through status, it would be pointless and unfair to adopt a more restrictive rule retroactively.

In addition, RICs which currently hold such investments may not be able to dispose of them freely, either because the market for a particular security may be thin or because doing so would cause the RIC to violate the "short-short" rule of Section 851(b)(3), which restricts gains from the sale of securities held for less than three months. Thus, we urge that the effective date of any change in the treatment of partnerships or trusts be postponed until 90 days after the date of enactment of the Bill.

III. Comments Relating to Section 851(b)(3).

A) Background

Section 851(b)(3) of the Code provides that a corporation will not qualify as a RIC for any taxable year unless less than 30% of the corporation's gross income is derived from the sale or other disposition of stock or securities held for less than three months (the "short-short rule"). It has been stated that the purpose of the

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[6] Alternatively, we recommend that the language added to Section 851(b)(2) by the Bill be revised to read as follows (our revision highlighted):

> dividends, interest, payments with respect to securities loand . . . and gains from the sale or other disposition of stock or securities . . . or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts but not including items of partnership or trust income or gain not otherwise described in this paragraph) derived with respect to its business of investing in such stocks, securities, or currencies;

short-short rule is to limit the amount of short-term, speculative trading in which a RIC may engage.[7]

Section 106(n)(2) of the Bill would amend Section 851(b)(3) to provide that a corporation will not qualify as a RIC during any taxable year unless:

> less than 30 percent of its gross income is derived from the sale or disposition of any of the following which was held for less than 3 months:
>
> (A) stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended),
>
> (B) options, futures, or forward contracts, or
>
> (C) except as provided in regulations, foreign currency.

B) Discussion

1) Section 106(n)(2) Change Should Be Prospective.

Under current law, gains arising on the sale of foreign currency and gains arising from certain types of options and futures contracts which are not "securities" are not considered short-short gains under Section 851(b)(3) since only gains from the sale or disposition of "securities" are limited. It is clear that the expansion of Section 851(b)(3) to include gains from items which are not securities, under either the statute or administrative practice as evidenced by private letter rulings, is not a "technical" correction, but is instead a significant substantive change in and expansion of current law, which one could argue is not an appropriate provision for a "technical corrections" bill. Moreover, as currently drafted (with retroactive effect), the proposed change could result in the disqualification of a RIC for pass-through treatment under Subchapter M. Given that the purpose of the restrictions on qualifying income is to regulate the behavior of RICs rather than to raise revenue through disqualification of pass-through status, it would be pointless and unfair to adopt a more restrictive rule retroactively. Thus, we strongly believe that the changes made by Section 106(n)(2) should apply to taxable years of RICs beginning after the enactment date of the Bill.

2) Treatment of Section 988 Gains.

A RIC can derive gains attributable to changes in the value of foreign currency relative to the U.S. dollar pursuant to Section 988 of the Code if the RIC invests in certain instruments denominated in foreign currencies. In the case of a foreign currency-denominated debt instrument, foreign currency gains may be attributable to payments of both interest and principal. The basic rationale behind Section 988 is that there is a direct relationship between foreign currency exchange rates and interest rates.[8] Section 988 treats such gains as ordinary income. Although the House of Representatives version of Section 988 specifically characterized foreign exchange gains as interest, the final version as adopted in the 1986 Act provides that to the extent provided in regulations, gains or losses under Section 988 shall be treated as interest income or expense (as the case may be).[9]

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[7] See, e.g., GCM 39316 (July 31, 1984); Rev. Rul. 75-376, 1975-2 C.B. 267; Blue Book p. 377 ("an appropriate requirement to ensure that a RIC is a passive entity").

The scope of section 106(n)(2) of the Bill as it affects foreign currency gains is unclear.

a) Foreign currency hedging activities should not give rise to short-short gains under Section 851(b)(3). RICs investing in foreign currency-denominated securities typically buy or sell forward contracts in foreign currencies to hedge their cost of a purchase or their proceeds of a sale between the trade date and delivery date. This practice represents conservative fund management rather than the type of churning activities at which section 851(b)(3) was aimed,[10] and thus any Section 988 gain arising from this practice should not be considered short-short gain. It is unclear whether it would be so treated under the proposed expanded Section 851(b)(3).

Similarly, RICs investing in foreign currency-denominated securities will hedge the U.S. dollar value of a foreign currency dividend, interest or principal payment. This practice also represents a conservative investment practice, and any Section 988 gains arising therefrom should not be deemed to give rise to any short-short gains under Section 851(b)(3).

A third instance in which comparatively short-term Section 988 gains can arise is one in which a RIC keeps a foreign (nonfunctional) currency (whether representing the proceeds of the sale of another foreign security or not) in a foreign bank account pending the purchase of another foreign security. This practice was generally sanctioned by the expanded definition of income qualifying under Section 851(b)(2) included in the 1986 Act. Any Section 988 gains arising from such accounts should, to the extent such gains fall within the broadened Section 851(b)(2), not be considered short-short gains within the meaning of Section 851(b)(3).

All three of the types of hedging activities here described represent sound, conservative investment practices which are in the interest of RIC shareholders, and the Section 988 gains arising therefrom should not be deemed to give rise to any short-short gains within the meaning of Section 851(b)(3), without regard to whether such gains may fit within the "designated hedge" exception of Section 851(g).

b) Non-hedging Section 988 gains should be considered short-short gains only in very limited instances. The potential applicability of the expanded short-short rule of proposed Section 851(b)(3) to other Section 988 gains is also unclear. For example, it is unclear whether exchange gain attributable to interest which has been accrued but not paid within the 3 months prior to the disposition of the instrument will be considered "short-short gain" under that provision.

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[8] H. R. Rep. No. 99-426, 99th Cong., 1st Sess. 467 (1985); S. Rep. No. 99-313, 99th Cong., 2d Sess. 452 (1986).

[9] Section 988(a)(2).

[10] See footnote 7, *supra*.

We believe that such foreign currency gains should generally be treated as less than 3-month gains only to the extent derived from assets (such as debt securities, non-equity options, futures contracts and forward contracts, but not including accrued interest or dividends) held for less than three months.

In view of our concerns with respect to Section 988 gains arising from both hedging and non-hedging activities, we suggest that the following sentence be added at the end of Section 851(b):[11]

> For purposes of paragraph (3), gains arising under Section 988 shall be treated as gains from an asset held less than 3 months only to the extent realized upon the sale or other disposition of an asset actually held for less than 3 months at the time of such sale or disposition. The payment of principal shall not constitute a sale or disposition of an asset for this purpose, and no amount attributable to accrued interest shall be treated as a gain from an asset held less than three months.

3) Treatment of Gains Under Section 1256(a).

Since Section 106(n)(2) of the Bill deals directly with the treatment of gains from options, futures and forward contracts under Section 851(b)(3), we believe that it would also be appropriate to deal with the effect of certain sections of the Code which affect the timing of gains or the holding period of investments by RICs.

For example, Section 1256(a) provides for the marking to market of "Section 1256 contracts" at the end of each taxable year. Gain or loss is taken into account as if each Section 1256 contract were sold for fair market value. RICs enter into many transactions involving Section 1256 contracts and the 1986 Act directly encourages investments in such items through its amendment to Section 851(b)(2) and the enactment of new Section 851(g).

If a RIC has realized a gain on a Section 1256 contract at the end of the year as the result of the "mark to market" rule, such gain could theoretically result in disqualifying gain under Section 851(b)(3) if the contract has been held for less than three months at year end. Such a result would not be justified since the RIC has not disposed of the contract, but merely is deemed to have sold the contract by virtue of the operation of tax rules which deem sales to occur at year end. Such "marked to market" gains do not result from short-term trading activities which were intended to be restricted under Section 851(b)(3).

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[11] It should be noted that there are several sentences at the end of Section 851(b) which modify the various paragraphs. Additional modifying sentences would be added if our suggestions are adopted. It may be appropriate to break each of the paragraphs in 851(b) into subparagraphs so that each modifying sentence is contained in the appropriate subparagraph.

The Internal Revenue Service has held in numerous private letter rulings that "marked to market" gains under Section 1256(a) do not result in disqualification of a RIC under Section 851(b)(3).[12]

Since only the taxpayer who requested a private letter ruling may rely on it, many RICs have had to, and continue to have to incur the additional cost of obtaining such a private letter ruling. We therefore believe that the following sentence should be added at the end of 851(b):

> For purposes of paragraph (3), gain arising by reason of Section 1256(a)(1) shall not be treated as gain from the sale of an asset held less than 3 months unless the Section 1256 contract is actually sold, disposed of or otherwise closed out before the corporation has a three-month holding period in such contract, and gain from the sale or other disposition of a Section 1256 contract shall be disregarded to the extent of losses previously taken into account with respect to that Section 1256 contract by reason of Section 1256(a)(1).

4) Suspension of Holding Period Under Section 1233, Section 1092 and Other Sections

Section 1233(b)(2) of the Code could result in the elimination of the holding period of a RIC in a particular investment if the RIC enters into a "short sale" or acquires an option to sell at a fixed price. The Internal Revenue Service has held that such an elimination of holding period would apply also for purposes of Section 851(b)(3).[13] We believe that such a result should not apply where the RIC has held the investment for 3 months or more prior to the short sale or acquisition of an option to sell at a fixed price.

Section 1092(b) of the Code may also result in the elimination of a RIC's holding period. The Treasury has provided in regulations that certain provisions of Section 1092(b) are not applicable for purposes of Section 851(b)(3).[14] We believe that such a result is proper. However, the Treasury has also provided that Section 1092(b) should be applied to eliminate a holding period for purposes of Section 851(b)(3) where Section 1233(b) would operate to terminate the relevant holding period.

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[12] See, e.g., GCM 39151 (March 1, 1984); PLRs 8348033 (August 30, 1983) and 8453019 (September 27, 1984); GCM 39316 (July 31, 1984); PLR 8504055 (October 30, 1984); GCM 39447 (December 5, 1984); PLRs 8518007 (January 18, 1985); 8522009 (February 25, 1985); 8533061 (May 21, 1985); 8538043 (June 26, 1985); 8548016 (August 29, 1985); 8548026 (August 30, 1985); 8549011 (August 30, 1985); 8552034 (September 26, 1985); 8610049 (Date not given); GCM 39526 (July 8, 1986). See also PLR 8612080 (December 27, 1985) (daily marking-to-market of gains and losses provided under Reg. §1.1092(b)-4T(c) is disregarded for purposes of §851(b)(3)); and Reg. §1.1092(b)-2T(d).

[13] See Rev. Rul. 74-434, 1974-2 C.B. 195.

[14] See Temp. Reg. § 1.1092(b)-2T(d).

We therefore suggest that the following sentence be added at the end of Section 851(b):

> For purposes of paragraph (3), the holding period of property shall not be eliminated under Section 1092(b) or 1233(b) if the property has been held for 3 months or more prior to the occurrence of any event resulting in the application of Section 1092(b) or Section 1233(b). The Secretary shall also have the power not to apply any sections of this title or regulations thereunder for purposes of paragraph (3) to the extent that such sections or regulations would otherwise result in an elimination, suspension or other modification of the holding period of property.

5) Liquidation of RICs.

We also believe that the following sentence should be added at the end of Section 851(b):

> For purposes of paragraph (3), in the case of the taxable year in which a regulated investment company is completely liquidated, there shall not be taken into account any gain from the sale, exchange, or distribution of any property after the adoption of the plan of complete liquidation.

A similar provision is contained in Section 106(p)(3) of the Bill in connection with the liquidation of real estate investment trusts.

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Re: Comments on the Technical Corrections Act of 1987

Dear Rob:

I am enclosing comments on the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) as prepared by members of various Tax Section committees. The comments were reviewed by members of the Committee on Government Submissions.

The enclosed comments represent the individual views of the members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Charles

Charles W. Hall
Chair, Section of Taxation

Enclosures

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4.	[Code section 2035]		Estate Tax

Notes:

REMICs. The comments on the Technical Corrections Act include as an exhibit a series of comments on issues which it is believed can be addressed in regulations.

Estate Tax. This proposes a technical amendment to Code section 2035 which was not amended by the Tax Reform Act of 1986.

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

COMMENTS ON PROPOSED SECTION 106(t) OF THE TECHNICAL CORRECTIONS BILL OF 1987

Technical Corrections Concerning Real Estate Mortgage Investment Conduits. Sections 860 A - 860 F of the Code

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The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

These comments were prepared under our direction by individual members of the Committee on Sales and Financial Transactions. Principal responsibility was exercised by George C. Howell, III, and Robert C. MacDonald, with assistance provided by Thomas R. Hood, Robert L. Cohen and Jeffrey T. Wax.

Dated: July 14, 1987

Members of the House of Representatives and Senate recently introduced companion versions of the Technical Corrections Act of 1987, H.R. 2636 and S. 1350, 100th Cong., 1st Sess. (1987), (the "Bill") containing technical corrections to the Tax Reform Act of 1986, including amendments to the Real Estate Mortgage Investment Conduit ("REMIC") sections of the Internal Revenue Code of 1986 (the "Code" or "I.R.C."). While many of the REMIC amendments are clerical, some of them are substantive. This memorandum comments upon some of the more significant REMIC provisions of the Bill and, in sections VII through XI, proposes certain additions to those provisions.

I. Repurchase of Mortgages.

Background: Although the disposition by a REMIC of a qualified mortgage generally is a prohibited transaction, current law permits a REMIC to substitute for a defective qualified mortgage within two years of closing. I.R.C. § 860G(a)(3)(B), (a)(4). Current law, however, contains no provision allowing a REMIC to cause the supplier of a defective mortgage to repurchase the mortgage, rather than replace it. The Bill would allow a REMIC to require such a supplier to repurchase a defective mortgage in lieu of substitution within the same two years. The status of the proceeds from a repurchase transaction is unclear. It appears that the REMIC must distribute them to its interest holders, although the statutory language does not explicitly prohibit the REMIC from instead using such proceeds to purchase a replacement mortgage within the calendar quarter. See I.R.C. § 860D(a)(4) (asset tests applied at the end of each calendar quarter).

Recommendation: The Bill should provide that proceeds from the repurchase of a defective qualified mortgage be treated as (i) proceeds arising from the prepayment of such mortgage, or (ii) at the option of the REMIC, as a defective qualified mortgage (for which a qualified replacement mortgage may be substituted) for a period of three months from the date of such repurchase.

Discussion: By authorizing puts of defective mortgages, the Bill acknowledges the similarity of such puts to other guarantee arrangements and increases REMIC flexibility. A REMIC that has disposed of a defective mortgage through a put, however, will hold cash that apparently will not be a qualifying REMIC asset. The REMIC either must distribute such cash or use it to purchase another qualified mortgage before the next quarterly test date. I.R.C. § 860D(a)(4). Put proceeds generally should be treated as prepayments on qualified mortgages. In some circumstances, however, a REMIC may wish to replenish its stock of qualified mortgages to prevent accelerated redemptions of its regular or residual interests. Because of the importance of call protection to the regular interest holders of most publicly issued REMICs and the lack of potential for abuse, the Bill or legislative history should clarify that, within the two year substitution period, a REMIC may use put funds to purchase a qualified replacement mortgage.

A REMIC forced to exercise a put near the end of a calendar quarter may find it difficult or impossible to locate and acquire an appropriate qualified mortgage before the test date. Given that a REMIC has no control over when a qualified mortgage becomes defective, it should not be penalized for exercising its puts near the end of a calendar quarter. Hence, the Bill should grant a grace period after the exercise of a put during which the put proceeds are considered as qualifying REMIC assets. A period of three months would conform to the length of the period after the startup day during which the REMIC may substitute mortgage collateral freely.

II. Abusive Mortgage Swaps.

Background: The Bill grants the Treasury authority to deny qualified replacement mortgage status to mortgages acquired by a REMIC in a "mortgage swap," rather than in a bona fide replacement transaction. Bill § 106(t)(11). The mortgage swap provision apparently targets abusive transactions in which recognition of gain on a swap of appreciated mortgages is deferred by swapping such mortgages between REMICs controlled by the exchanging parties. Neither the Bill nor the Description of the Technical Corrections Act of 1987 prepared by the Staff of the Joint Committee on Taxation (JCS-15-87, June 15, 1987)(the "Committee Explanation") so indicates, however. In addition to granting the Treasury authority to regulate against mortgage swaps, the Bill grants authority to provide rules for the treatment of substitutions of qualified replacement mortgages where the source of such mortgages is a regular or residual interest holder. According to the Committee Explanation, the rules to be issued are (i) to determine the basis of the mortgages transferred to or received from the REMIC and (ii) to determine or adjust the basis of the REMIC's qualified mortgages before or after the replacement transaction. Committee Explanation at 59.

Recommendation: The language of the mortgage swap provision should provide an example of a mortgage swap and indicate that the provision is not designed to cover bona fide substitution transactions.

Discussion: The Bill's grants of regulatory authority are very broad, and the Committee Explanation sheds little light on their intended targets. Because of uncertainty as to what circumstances constitute a forbidden mortgage swap, there may be a chilling effect on bona fide mortgage substitution transactions.

III. Startup Day.

Background: Current law does not require a REMIC to issue all of its interests on the same day. Under the Bill, however, all of the REMIC's regular and residual interests must be issued on the startup day. Bill § 106(t)(6)(E). At the same time, to be a qualified mortgage under the Bill, an item of mortgage collateral must be transferred to the REMIC on the startup day, or purchased by the REMIC within three months of the startup day pursuant to a fixed price contract in effect on the startup day. Bill § 106(t)(6)(C). Thus, all of the mortgage collateral must be acquired either (i) on the REMIC's startup day or (ii) pursuant to a fixed price contract in effect as of the REMIC's startup day. The meaning of fixed price contract is not clear, however.

The Bill authorizes the Treasury to provide regulations that would treat issues from, and transfers to, the REMIC during a certain period (not to exceed ten days) as having taken place on the startup day. Bill § 106(t)(6)(E).

Recommendations: The meaning of fixed price contract should be clarified. To qualify as a fixed price contract, a contract should not be required to identify the qualified mortgages precisely, as long as such mortgages are specified as to: (i) type (*e.g.*, GNMA Certificates, whole loans, etc.); (ii) weighted average coupon or pass-through rate, with a tolerance for some variation such as plus or minus 0.25 percent; and (iii) weighted average maturity, also allowing some variation such as one to two years. In addition, the Bill should provide that transfers of assets to, and issuances of interests by, the REMIC within a ten day period that includes the startup day will be treated as having taken place on the startup day, unless the Treasury issues regulations to the contrary. The Bill should specify that any such regulations will be prospective only.

Discussion: Current law allows a REMIC, after having sold its regular interests, to purchase its collateral at whatever market price prevails at the time of purchase. It is unclear whether, and if so when, the contributors of the REMIC's collateral recognize arbitrage gain (or any other gain inherent in the mortgages) in such a situation. The Bill's startup day rules and fixed price contract requirement apparently are designed to fix the amount of such gain on the startup day.

Due to the practical difficulties involved in achieving delivery of large amounts of collateral on a single startup day, many public REMIC transactions would depend upon fixed price contracts for REMIC qualification under the Bill. The requirements of such contracts, however, are unclear. The Committee Explanation indicates that, under a fixed price contract, the purchase price of qualified mortgages may not be adjusted to account for fluctuations in their market value between the startup day and the delivery date, but gives no further guidance.

Committee Explanation at 59 n.18. It is unknown whether the contract must identify specific collateral (e.g., by pool number in the case of mortgage certificates) or whether it may call for any collateral meeting certain specifications. In the typical public REMIC offering, although specific collateral often is identified at the time of pricing, some or all of the collateral actually delivered is not the collateral originally identified. The collateral actually delivered, however, will conform to given parameters. That practice does not appear conducive to abuse in the context of publicly registered REMIC offerings because the prospectuses by which such offerings are sold permit only slight variations in the characteristics of the collateral to be acquired. A requirement that all collateral be specifically identified at closing would add unnecessary complication and cost to REMIC offerings. The Bill should provide, therefore, that collateral need not be specifically identified in a fixed price contract as long as the collateral delivered conforms to parameters specified in the prospectus or the purchase contract.

Recognizing the complexity of the typical REMIC transaction, the Bill authorizes the Treasury to treat transfers to, and issuances by, a REMIC as having been made on the startup day if such transfers or issuances take place within a period of up to ten days. Until the Treasury issues regulations authorizing such a grace period, however, the harsh single-day rule would apply. Under the Bill as drafted, a transaction that would have qualified for REMIC treatment if a grace period were provided might be cancelled immediately prior to the scheduled closing, at great cost to both the issuer and the underwriter, if technical problems prevent the participants from completely closing the transaction in a single day. The Bill's failure to grant the grace period immediately adds unnecessary uncertainty to REMIC transactions and should be remedied.

IV. Qualified Mortgages.

Background: Current law generally defines a qualified mortgage as "any obligation ... which is principally secured, directly or indirectly, by an interest in real property...." I.R.C. § 860G(a)(3). Under the Bill, the "directly or indirectly" language would be eliminated. Bill § 106(t)(7)(A). That change comes in response to the footnote in the General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation (JCS-10-87, May 4, 1987) (the "General Explanation") calling for a technical correction to deny qualified mortgage status to non-REMIC debt instruments secured by other debt instruments, even where those other debt instruments would qualify for such status. General Explanation at 413 n.67.

Recommendation: Section 106(t)(7)(A) of the Bill should be amended to adopt language that is no more expansive than that found in footnote 67 of the General Explanation.

Discussion: According to the General Explanation, "except for regular interests in a REMIC, Congress did not intend that debt obligations that are secured primarily by other debt obligations would be treated as qualified mortgages even where such other debt obligations are secured primarily by interests in real property." General Explanation at 413 n.67. The footnote in the General Explanation clearly seems aimed at non-REMIC collateralized mortgage obligations and "funding notes." The statutory response, however, arguably could be read to rule out qualified mortgage status for mortgage debt secured by an interest in a pass-through trust holding real property or some other bona fide security arrangement. A more precise remedy would be for the Bill to track the language of the footnote.

It should be noted that this memorandum takes no position with respect to whether excluding non-REMIC collateralized mortgage obligations and funding notes from the definition of qualified REMIC assets is appropriate, because two of the principal draftsmen are members of a law firm that has been engaged to represent a client with respect to that issue.

V. Tax on Net Income from Foreclosure Property.

Background: Under current law, foreclosure property is a qualified REMIC asset for one year after its acquisition. I.R.C. § 860G(a)(8). The Bill generally would extend the period of qualification to two years, but would institute a REMIC-level tax at the highest corporate rate on certain types of net income from such property. The Bill incorporates the definition of net income from foreclosure property used for real estate investment trusts ("REITs"). Under the REIT rules, net income from foreclosure property includes: (i) gain from the sale or disposition of property held for sale in the ordinary course of business ("section 1221(1) property"), which presumably would not apply in the case of most REMICs; and (ii) income from foreclosure property other than rents from real property, interest on obligations secured by real property, gain from the sale of property other than section 1221(1) property, REIT dividends, and certain other types of income. In the case of the typical REMIC, most or all of the income from its foreclosure property would not be subject to the tax.

Recommendation: The tax on net income from foreclosure property should be eliminated from the Bill.

Discussion: The tax on net income from foreclosure property would reach little or no income in the case of the typical REMIC, while adding unnecessary complexity.

VI. Contributions to the REMIC after Closing.

Background: The treatment of contributions to a REMIC after closing is unclear under current law. The Bill effectively would prohibit post-startup day contributions by subjecting such contributions to a tax equal to 100 percent of the contributed amount. Bill § 106(t)(10)(A). That tax would apply to REMICs whose startup day (as defined under present law) is on or after July 1, 1987. Bill § 106(t)(10)(B).

Recommendation: We believe that the tax on contributions should be eliminated from the Bill because the asset qualification tests already provide sufficient protection against unreasonable accumulation of assets in a REMIC. At a minimum, however, the following types of post-startup day contributions should be excepted from the scope of the tax: (i) payments made pursuant to a guarantee or similar credit enhancement arrangement with respect to qualified mort gages, cash flow investments, or qualified reserve assets; (ii) contributions of funds by residual interest holders that are reasonably required to provide for full payment of REMIC expenses or amounts due on regular interests; and (iii) contributions of funds by residual interest holders for the purpose of effecting "clean-up" redemptions of REMIC regular interests.

Discussion: The confiscatory tax on post-startup day contributions is the most troublesome aspect of the REMIC amendments proposed by the Bill. If the tax is not eliminated from the Bill or substantially modified, it would have a significant adverse impact on REMIC offerings that could not have been intended by the draftsmen. For example, REMIC residual interest holders generally are liable for REMIC expenses, such as administrative expenses and professional fees incurred in connection with a tax audit of the REMIC, to the extent that such expenses exceed the residual cash flow produced by the REMIC's assets. The imposition of a 100 percent tax on contributions to pay such expenses would bring the operations of the REMIC to a halt and would force the REMIC into liquidation or default. It often is not possible to provide adequate reserves for expenses such as administrative expenses based on a "cost plus" formula and professional fees because the amount of such expenses cannot be estimated accurately on the REMIC's startup day.

Although the purpose of the tax on contributions is not entirely clear, it seems intended to accomplish one or both of the following objectives: (i) to prevent unreasonable accumulations of assets inside a REMIC, see, e.g., General Explanation at 426-27; or (ii) to prohibit partial redemptions of REMIC regular interests. If the goal of the tax on contributions is to prevent unreasonable asset accumulations, the enactment of the tax is unwarranted. In the context of a publicly registered REMIC offering, it is unlikely that such accumulations will occur because generally neither the interest holders nor the promoter have an incentive to create them. Moreover, the Bill's new startup day rules effectively prohibit such accumulations since a REMIC may have only a de minimis amount of non-qualifying assets and the amount of qualified mortgages that a REMIC may possess is determined on its startup day. See section III supra. The amount of qualified mortgages, in turn, will determine the REMIC's reinvestment income and, thus, the amount of its cash flow investments. The amount of a REMIC's qualified reserve assets is restricted by the definition of "qualified reserve fund." I.R.C. § 860G(a)(7)(B). Finally, an increase in the amount of a REMIC's foreclosure property will be offset by the corresponding decrease in its pool of qualified mortgages.

Because the asset qualification tests are applied at the close of each calendar quarter, it is possible to fund a REMIC with nonqualifying assets between test dates. I.R.C. § 860D(a)(4). While the contributions tax would foreclose that possibility, the same end could be accomplished by making the REMIC qualification test continuous. Presumably, however, the original REMIC legislation avoided the latter approach in order to allow for brief periods of noncompliance brought about by unusual circumstances.

If the objective of the contributions tax is to prohibit partial redemptions of REMIC regular interests, it is unclear what abuse the tax is designed to prevent. Partial redemptions can be divided into two broad categories: (i) economic calls; and (ii) "clean-up" calls. Economic calls give residual interest holders an opportunity to refinance the REMIC's assets or to replace debt (in the form of regular interests) with equity. Clean-up calls are purely ministerial calls that permit the REMIC to call a class of regular interests when the outstanding principal amount of that class has been reduced to the point where the administrative expenses associated become unduly burdensome. Clean-up calls typically are permitted when the outstanding principal amount of a regular interest class reaches either 10 or 20 percent of its original amount. Even if economic calls somehow are viewed as inconsistent with the passive nature of REMICs, there is no tax policy reason to prohibit clean-up calls.

In summary, the contributions tax would reduce unnecessarily the residual interest holders' flexibility in dealing with their REMIC. Specifically, the tax, as currently drafted, would block two types of nonabusive transactions that could be important to the viability of publicly registered REMICs. First, it would prevent contributions made to prevent default on regular interests or to pay REMIC expenses. Second, it effectively would prohibit partial redemptions of regular interests, including clean-up calls. See Members of the ABA Tax Section REMIC Task Force, Comments Regarding Regulations to be Issued under the REMIC Provisions of the Tax Reform Act of 1986 11-13 (June 7, 1987) (the "June 7 Submission") (attached).

VII. Governmental Pass-through Trust Certificates.

Background: The qualification rules provide that substantially all of the assets of a REMIC must consist of qualified mortgages and permitted investments. I.R.C. § 860D(a)(4). Mortgage replacement or substitution is permitted only in specified cases and a 100 percent prohibited transaction tax is assessed on improper dispositions. I.R.C. §§ 860F, 860G. The legislative history of the Tax Reform Act of 1986, which introduced the REMIC provisions, states that the conferees intended that interests in a grantor trust would be treated as qualified mortgages to the extent that the assets of the trust would be treated as qualified mortgages. H.R. Rep. No. 841, 99th Cong., 2d Sess. (the "Conference Report") II-227 n.5 (1986). Thus, an interest in a properly comprised grantor trust, as opposed to the assets underlying such a trust, will be treated as the qualifying REMIC asset.

Recommendation: The Bill should provide that, with respect to a grantor trust interest that is treated as a qualified mortgage, subsequent transactions relating to the mortgages underlying the grantor trust will have no effect on continuing REMIC status and will not give rise to a prohibited transaction. To eliminate any potential for abuse, regulatory authority could be provided to prevent the use of grantor trusts as a means of avoiding the REMIC limits on substitution and repurchase.

Discussion. The standard provisions for repurchase or substitution of the mortgages underlying a grantor trust may not always be consistent with the REMIC repurchase or substitution limits. However, in the absence of control over either mortgage terms or trust administration by REMIC sponsors or investors, there is no potential for avoidance or manipulation of the REMIC qualification or prohibited transaction rules with respect to investment in such a trust.

VIII. Mortgage Substitution and Repurchase.

Background: Substantially all of the assets of a REMIC must consist of qualified mortgages and permitted investments. I.R.C. § 860D(a)(4). The definition of a qualified mortgage (i.e., an obligation principally secured by an interest in real property that is property transferred to the REMIC) includes a qualified replacement mortgage. I.R.C. § 860G(a)(3)(B). A qualified replacement mortgage is an obligation which, in addition to satisfying certain other rules, is received by a REMIC either for another obligation within a three-month period beginning on the startup day or for a defective obligation within a two-year period beginning on the startup day. I.R.C. § 860G(a)(4).

A REMIC is subject to a tax equal to 100 percent of the net income derived from any prohibited transaction. I.R.C. § 860F(a). One type of prohibited transaction is the disposition of a qualified mortgage, other than a disposition pursuant to the substitution of a qualified replacement mortgage or incident to the foreclosure, default or imminent default of the mortgage (or for other specified reasons). I.R.C. § 860F(a)(2)(A).

Recommendation: The Bill should eliminate the two-year limitation on substitution and repurchase of qualified mortgages in cases where the substitution or repurchase is due to a defective mortgage or is incident to the imminent default of a mortgage.

Discussion: The right of mortgage substitution or repurchase without either causing the disqualification of the REMIC or subjecting the REMIC to a prohibited transaction tax should not be limited to a two-year period in cases where such substitution or repurchase is due to a defective mortgage or is incident to the imminent default of a mortgage. In neither of these situations does there exist the realistic possibility of abuse or manipulation. For business reasons, a substitution right for defects or imminent default in years subsequent to the second year is equally as important to a purchaser as a right limited to the initial two-year period. Moreover, in an arm's-length transaction, it is highly likely that a substituted mortgage will contain terms the same as, or substantially similar to, those contained in the original mortgage. Thus, a more liberal substitution rule would not seem to create a possibility for varying the investments of the REMIC. Among other desired effects, relief from the two-year limitation in such cases would prevent accidental disqualification where, for example, a mortgage that is about to default is materially renegotiated after the two-year period, resulting in an exchange under Section 1001 of the Code.

IX. Qualified Reserve Funds.

Background: Permitted investments of a REMIC include qualified reserve assets. I.R.C. § 860G(a)(5)(B). In order to constitute a qualified reserve asset, an asset must be held as part of a qualified reserve fund, which is defined to mean any reasonably required reserve to provide for the full payment of the expenses of a REMIC or the amounts due on regular interests in the event of a default on a qualified mortgage. I.R.C. § 860G(a)(7). The amount of such reserve is required to be reduced promptly and appropriately as payments of qualified mortgages are received. Id. The Bill also would provide that a qualified reserve fund may take into account, in addition to amounts needed for expenses or possible mortgage defaults, reasonable amounts held to protect against lower-than-expected returns on cash flow investments. Bill § 106(t)(8).

Recommendation: The Bill should provide that amounts required to be held in a reserve fund to obtain a guarantee, an insurance policy or a letter of credit (pursuant to the requirements of a guarantor, an insurance company or a letter of credit provider) or to obtain a favorable rating (pursuant to the requirements of a rating agency) will be deemed to be "reasonably required" (and thus, will constitute a qualified reserve fund) and will be deemed to satisfy the "prompt and appropriate" reduction standard.

Discussion: As indicated in the June 7 Submission, all mortgage-backed security offerings to date have employed some form of credit enhancement (e.g., governmental agency guarantees, private pool insurance, letters of credit and private guarantees). June 7 Submission at 6-11. Private guarantors, insurers, and letter of credit providers commonly require the maintenance of reserve funds at specified levels as a condition to the issuance of the guarantee, insurance policy or letter of credit. Similarly, rating agencies may require specified reserves as a condition to the issuance of a favorable rating. Reserves funded pursuant to such requirements appear, under current law, to meet the "reasonably required" test. Moreover, the maintenance of reserves at the levels specified by third-party credit providers or rating agencies similarly appears to meet the "prompt and appropriate" reduction standard of current law.

However, in view of the significance of reserves to the marketability of REMIC interests (and, thus, the likelihood that reserves will be required in a significant number of REMIC offerings), the Bill should provide that the amount of any reserve fund at any particular time will be deemed to be "reasonably required" and in compliance with the "prompt and appropriate" reduction standard if maintained pursuant to the requirements of a guarantor, insurer or other provider of credit enhancement (such as a letter of credit bank) or the requirements of a rating agency.

X. Treatment of Certain Rights Appurtenant to Qualified Mortgages as Qualified REMIC Assets.

Background: Substantially all of the assets of a REMIC must consist of qualified mortgages and permitted investments. I.R.C. § 860D(a)(4). The receipt of any income attributable to any asset which is neither a qualified mortgage nor a permitted investment constitutes a prohibited transaction subject to the 100 percent tax. I.R.C. § 860F(a)(2)(B). It is not clear whether certain rights appertaining to a mortgage which provide for payments of amounts due under the mortgage (whether in lieu of scheduled payments or in addition to or in advance thereof) will themselves constitute a qualified mortgage or be considered part of a qualified mortgage so as to avoid jeopardizing REMIC status or causing a prohibited transaction.

Recommendation: The Bill should state that a right appertaining to a qualified mortgage which provides for payments of amounts due under the mortgage (whether in lieu of scheduled payments or in addition to or in advance thereof) will not be treated as an asset of the REMIC separate from the qualified mortgage.

Discussion: The Bill should specify that a right appertaining to a qualified mortgage which provides for payments of amounts due under the mortgage (whether in lieu of scheduled payments or in addition to or in advance thereof) would not be treated as an asset of the REMIC separate from the qualified mortgage. Thus, payments under such right would not jeopardize REMIC status, give rise to a prohibited transaction or result in the imposition of the 100 percent contributions tax. For example, Farmers' Home interest rate subsidies, pool insurance, servicer advances, third-party (i.e., seller) contributions on account of negative amortization of mortgages or "buy-down" arrangements and other similar rights should not be considered separate, nonqualified REMIC assets (and, hence, should neither jeopardize REMIC status nor give rise to the 100 percent prohibited transaction or contributions tax when payments with respect to these rights are received).

XI. Distribution of Income From Cash Flow Investments.

Background: A cash flow investment is any investment of amounts received under qualified mortgages for a temporary period before distribution to holders of REMIC interests. I.R.C. § 860G(a)(6). The legislative history of the REMIC provisions indicates that Congress intended that the income from cash flow investments would be distributed to investors at the next succeeding regular payment date. Conference Report at II-227.

Recommendation: The requirement to qualify as a cash flow investment should be liberalized by the Bill to permit distributions with respect to cash flow investments no later than the second succeeding regular payment date after the related mortgage payment.

Discussion: In certain circumstances (e.g., delayed remission by a servicer or a minimum required period of investment in a cash flow investment), mortgage receipts cannot be distributed on the next succeeding regular payment date. It is recognized that some time limitation is advisable to avoid, for example, unreasonable accumulation inside a REMIC. Generally, servicer delays and minimum investment periods will not exceed two regular payment periods.

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

COMMENTS REGARDING REGULATIONS TO BE ISSUED UNDER THE REMIC PROVISIONS OF THE TAX REFORM ACT OF 1986

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

The comments were prepared under our direction by individual members of the REMIC Task Force which consists primarily of members of the committees on Sales and Financial Transactions, Real Estate Tax Problems, Regulated Investment Companies, and Tax Exempt Financing. Principal drafting responsibility was exercised by Peter J. Connors, George C. Howell, III, and Robert C. MacDonald. Also contributing were Keith A. Dunsmore, Howard M. Fields, Peter F. Hiltz, Thomas A. Humphreys, Steven L. Paul, and Kenneth G. Whyburn. The proposals were reviewed by Daniel S. Knight, Albin C. Koch, and Louis W. Ricker of the Section's Committee on Government Submissions. Although several members of the REMIC Task Force actively represent clients with respect to REMICs, no member of the Task Force has, to the best of our knowledge, been engaged by a client to comment on any of the issues specifically addressed in this report.

Dated: June 8, 1987

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Committee on Sales and Financial Transactions Comments Relating to REMIC Regulations

This memorandum discusses issues relating to real estate mortgage investment conduits ("REMICs") that we believe are important enough to be addressed in the first set of regulations, but that, to the best of our knowledge, have not been covered by other written submissions to the Tax Legislative Counsel or the Internal Revenue Service (the "Service"). We hope to submit a more comprehensive discussion of REMIC issues after the first set of regulations has been released.

Two guiding principles underlie the recommendations set forth below: (i) the REMIC provisions of the Internal Revenue Code of 1986 (the "Code" or "I.R.C.") ought to be construed broadly to permit maximum flexibility in structuring transactions and (ii) the regulations promulgated under those provisions should be as administratively simple as possible, except in situations where simplicity would create a significant risk of tax avoidance or abuse. Those two principles support what we believe are the broad policy goals of the REMIC provisions, namely, to lower mortgage interest rates by reducing transactional costs in the secondary mortgage market and to assure uniform taxation of mortgage-backed securities. In order to achieve those goals, the tax administration system relating to mortgage-backed security offerings should be simplified, and tax uncertainties should be kept to a minimum. Furthermore, absent potential tax avoidance or abuse, the benefit to the marketplace of simplified tax administration and reduced uncertainty should be maximized by extending the coverage of the REMIC rules to as many types of transactional structures as possible.

I. REMIC Qualification

A. Residual income received in exchange for services to the REMIC

Issue

A REMIC must have one, and only one, class of residual interest. I.R.C. § 860D(a). A residual interest is any interest in a REMIC that (i) is not a regular interest and (ii) is designated as a residual interest by the REMIC. I.R.C. § 860G(a)(2). The legislative history of the Tax Reform Act of 1986 (the "Act") states that a "right to receive payment from [a] REMIC for goods or services rendered in the ordinary operation of the REMIC" is not to be treated as an interest in the REMIC. H.R. Rep. No. 841, 99th Cong., 2d Sess. (the "Conference Report") II-229 (1986). In many cases, however, such rights to payment arguably resemble residual interests and, if treated as such, could give rise to a prohibited second class of residual interest.

Comment

The risk of REMIC disqualification makes it essential to distinguish persons receiving payments from the REMIC in exchange for services from residual interest holders. Under prevailing industry practices, fees for certain types of services ("principal-based fees") are paid on an ongoing basis over the life of the REMIC and are based, directly or indirectly, upon the outstanding principal amount of the REMIC's collateral, which declines over time as principal payments are received. Bond administration fees and mortgage servicing fees are examples of principal-based fees that appear in all REMIC and non-REMIC collateralized mortgage obligation ("CMO") offerings. Annual bond administration fees typically range from 4 to 7.5 basis points (0.04 percent to 0.075 percent) of the average principal balance for the year in question of the regular interests or CMOs being administered. Annual servicing fees normally run from 25 to 50 basis points of the average principal balance of the mortgage loan pool being serviced. Other common examples of principal-based fees include pool insurance premiums, special hazard insurance premiums, and master servicing fees. Principal-based fees arose as the practical solution to the problem of having sufficient cash flow throughout the life of a bond offering or mortgage loan pool to pay a fixed amount that would compensate the service provider adequately. Consequently, the continued use of principal-based fees is essential to the efficient functioning of the mortgage-backed security market under the REMIC regime.

In the case of a bond administrator or mortgage loan servicer, there generally is a close correlation between the number of bonds or mortgage loans outstanding and the level of effort required. Although there is some correlation between the outstanding principal balance and the size of the administrative or servicing task, the former typically declines more rapidly than the latter. Consequently, a principal-based service provider attempts to make enough profit in the early years when principal balances are high to compensate it for losses in the later years when principal balances are low.

It can be argued that principal-based fees resemble residual cash flows somewhat in that the total amount of fees received and, in many cases, the amount of profit earned by the service provider depend upon the prepayment rate experienced with respect to the mortgage assets securing the offering. Principal-based fees, however, should not be treated as residual interests for three reasons. First, such fees are received at a market-determined rate in exchange for services provided in the ordinary operation of the REMIC, and not as a return on any sort of capital investment in the REMIC. Consequently, principal-based fees should fall squarely within the exclusion from residual interest status provided by the legislative history. Conference Report at II-229.

Second, the economic behavior of a principal-based fee varies significantly from that of a typical residual interest. Residual cash flow generally includes at least two components whose behavior differs from that of a principal-based fee: (i) variable bond interest differential, which is the residual cash flow attributable to the differential between the rate on a given bond class and the highest bond rate and (ii) excess reinvestment income, which is reinvestment income in excess of that necessary to service the bonds. In the typical REMIC offering, the magnitude of bond interest differential is greatest during the early years of the REMIC's life because the upward-sloping yield curve that historically prevails in the debt market results in short-term bond (or regular interest) classes having more bond interest differential than longer-term classes. When only a single bond class remains outstanding, bond interest differential generally disappears since that class normally bears the highest interest rate. Consequently, the amount of bond interest differential received by a residual interest holder depends almost solely on the prepayment rate experienced during the early years of the REMIC, while the amount of a principal-based fee depends on the prepayment rate experienced over the life of the REMIC. Furthermore, the amount of excess reinvestment income earned is a function of short-term interest rates, which may bear little relationship to the rate of mortgage prepayments. Thus, the economic behavior of a principal-based fee may differ significantly from that of a residual interest.

Third, the economic behavior of a principal-based fee is identical to that of a "coupon strip." A coupon strip arises when ownership of an interest amount is separated from ownership of the principal amount to which it is attributable. I.R.C. § 1286(e). For example, the originator of a 10 percent mortgage loan might "strip" or retain ownership of 200 basis points (2 percent) of interest over the life of the loan and sell the right to the remaining principal and interest payments to be received on the loan (i.e., sell the equivalent of an 8 percent mortgage loan) to a REMIC. The legislative history indicates that stripped coupons and stripped bonds are qualified mortgages for REMICs if the debt instruments from which they were derived would have been treated as such. Conference Report at II-227 n.5. In permitting REMICs to hold stripped bonds, Congress recognized that the stripped coupons do not give rise to a second class of residual interest. Jt. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986 (the "General Explanation") 416 (1987); see also Reg. § 301.7701-4(c), Example (4) (since stripped coupons and stripped bonds are considered separate obligations under section 1286 of the Code, the owner of a stripped coupon is not viewed as having an additional class of interest in a grantor trust that owns the underlying mortgage loan). That position accords with the prevailing industry practice of partially stripping mortgage collateral before pooling it. A GNMA Certificate, for example, represents an interest in stripped bonds because interest from the underlying mortgage loans in excess of the pass-through rate plus 50 basis points is retained by the originator or servicer as "excess servicing."

Principal-based fees could be (and sometimes are) structured as partial interest strips of qualified mortgages so that the fee is paid outside of the REMIC. In such a case, the owner of a principal-based fee stream would not be treated as having any interest in the REMIC that owns the resulting stripped mortgage loans. The result should be no different where the fee stream is derived from cash flows within the REMIC (i.e., where the regular interest holders are paid ahead of the service provider). Thus, principal-based fees for services, like coupon strips, should not be considered to create a prohibited second class of residual interest.

Recommendation

The regulations should provide that arm's-length principal-based fees such as servicing and bond administration fees do not give rise to a prohibited second class of residual interest.

B. Subordinated regular interests

Issue

The qualification rules provide that a REMIC may not have more than one class of residual interest. I.R.C. § 860D(a)(3). In discussing the impact of the subordination of interests on REMIC qualification, the Conference Report states that "an interest in a REMIC would not fail to be treated as a regular interest if the payments of principal (or similar) amounts with respect to such interest are subordinated to payments on other regular interests in the REMIC, and are dependent upon the absence of defaults on qualified mortgages." Conference Report at II-228; see also General Explanation at 415 (clarifies that both principal and interest payments may be subordinated to payments on other regular interests). That statement, by omitting a reference to residual interests, could be read to imply that subordination to a residual interest causes a REMIC interest that otherwise would be treated as a regular interest to be classified as a prohibited second class of residual interest.

Comment

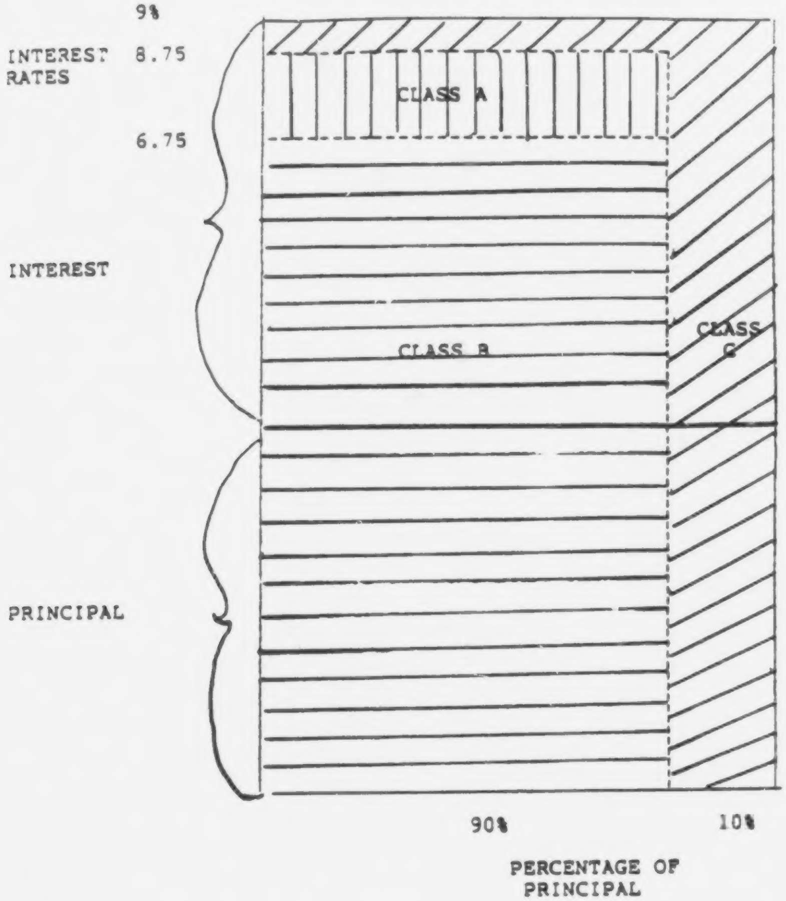
The subordination to a residual interest of an interest that otherwise qualifies as a regular interest could occur in a number of relatively common types of mortgage-backed security offerings. For example, a REMIC might hold 9 percent mortgage loans and have two classes of senior interests and one class of subordinated interest. Assume that the senior classes together are entitled to 90 percent of the principal and an 8.75 percent interest rate and that the subordinated class (the "C" class) is entitled to 10 percent of the principal and the remaining interest. Assume further that one senior class (the "A" class) is entitled to 2 percent of the 8.75 percent interest and no principal and the second senior class (the "B" class) is entitled to all of the principal and the remaining interest allocable to the senior classes. See chart on following page. Absent a subordination issue, both the B and C classes would qualify as regular interests, and the A class would be the only residual class. If, however, subordination to a residual interest causes an interest to be treated automatically as a residual interest, the structure would violate the prohibition against two classes of residual interests.

The subordination of a regular interest to a residual interest does not present any opportunities for tax avoidance or abuse. If there are defaults on the mortgage collateral, the tax consequences to the holder of the subordinated interest would be no different than if the interest had not been subordinated and there had been enough defaults to cause a shortfall with respect to unsubordinated interests. Furthermore, the consequences of subordination to a residual interest are no different than if the regular interest had been subordinated to another regular interest, as authorized in the legislative history. Conference Report at II-228. Consequently, from a tax policy standpoint, subordination of regular interests to residual interests should be permitted in order to avoid denying the benefits of REMIC status to transactional structures that involve such subordination.

Recommendation

The regulations should clarify that subordination to a residual interest does not cause a REMIC interest that otherwise would be treated as a regular interest to be classified as a residual interest.

CHART



C. Collateralized default guarantees

Issue

In the past, the rating agencies generally have required issuers of collateralized mortgage obligations ("CMOs") that are secured by uncertificated mortgage loan pools (*i.e.*, pools for which credit enhancement and securitization have not been provided by GNMA, FNMA, or FHLMC) to obtain insurance against certain types of default risks. Because such insurance policies have become increasingly expensive, several CMO issuers, working in conjunction with the rating agencies, have designed arrangements in which insurance policies would be replaced with guarantees against default provided by the issuer or the person who sells the mortgage collateral to the issuer. In situations where the guarantor has a credit rating lower than the desired rating on the CMO offering, the guarantee would be secured by a reserve fund comprised typically of mortgage loans, mortgage certificates, or short-term rated securities. Cash flow from the the reserve fund would be diverted to make payments on regular interests (and perhaps residual interests) only to the extent necessitated by defaults on primary mortgage collateral.

In cases where a guarantee reserve fund is comprised of uncertificated mortgage loans, the number of mortgage loans in the reserve fund must reach a certain level (typically 300 loans) in order for the law of large numbers to come into play and the overcollateralization mechanism to become efficient from a rating agency viewpoint. If the number of loans initially placed in the reserve fund is less than the specified number, the level of overcollateralization that would be required by the rating agencies would rise substantially. A low-volume originator of mortgage loans, therefore, would be at a serious disadvantage unless a single reserve fund can be used to secure guarantees with respect to mortgage loans collateralizing more than one CMO offering. It is anticipated that the rating agencies will permit such crosscollateralization of guarantees in order to reach an efficient reserve fund size.

In most situations, the persons who sell mortgage collateral to a CMO issuer would provide the default guarantees because they are in a better position than the issuer to assess the default risks inherent in the mortgage loans being sold to the issuer. Each seller would guarantee only the mortgage loans that he sells to the issuer (the "sold collateral"). Sellers who have a credit rating less than the rating desired for the CMO offering would provide reserve assets sufficient to meet the collateralization requirements of the rating agencies. Any assets or cash flow in a seller's reserve fund in excess of that needed to fund defaults with respect to his sold collateral would be returned to the seller as soon as permitted by the rating agencies.

The qualification rules require that substantially all of a REMIC's assets consist of certain types of assets, including assets that are part of a qualified reserve fund. I.R.C. §§ 860D(a)(4), 860G(a)(5). A qualified reserve fund is defined as a reserve comprised of intangible investment assets that is reasonably required . . . to provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages." I.R.C. § 860G(a)(7). The balance of a qualified reserve fund must "be promptly and appropriately reduced as payments of qualified mortgages are received." *Id.* Furthermore, a REMIC may have no more than one class of residual interest. I.R.C. § 860D(a)(3).

The composition of a REMIC's assets controls the extent to which its regular and residual interests constitute qualifying assets in the hands of thrift institutions and real estate investment trusts ("REITS") for certain tax purposes. *See* I.R.C. §§ 593(d)(4) (thrift bad debt reserves), 856(c)(6)(E) (REIT qualification), 7701(a)(19)(c)(xi) (thrift institution qualification). Although REMIC interests generally are treated as qualifying assets for such purposes in the same proportion that the REMIC's assets would be so treated if held directly by the thrift institution or REIT, a de minimis safe harbor applies if the proportion of the REMIC's assets that would meet the various qualification tests is at least 95 percent. Id.

It is unclear whether collateral items securing a seller guarantee would be treated as assets of the REMIC and, if so, whether the seller's ownership interest in the collateral would be treated as a prohibited second class of residual interest. If the collateral securing a seller guarantee were to be treated as part of a REMIC's assets, the proportion of the REMIC's interests that constitute qualifying assets for thrift institutions and REITs would be reduced to the extent that the collateral was comprised of nonqualifying assets. Moreover, it is unclear whether the use of a single collateral pool to secure guarantees with respect to multiple REMIC offerings would prevent that pool from being treated as a qualified reserve fund.

An additional aspect of overcollateralization funds that is in need of clarification concerns the tax ownership of sold collateral that is subject to a seller guarantee against default. The Service has refused to provide advance rulings on whether purported sales of securities will be treated as dispositions when the acquirer of the securities has the contractual right to cause the seller to repurchase them. Rev. Proc. 83-55, 1983-2 C.B. 572. Since a seller guarantee could be structured (or recharacterized) as a guarantee on the part of the seller to redeem or to replace defective sold collateral, the Service conceivably could take the position that a transfer of sold collateral to a REMIC is not a disposition of the collateral for federal income tax purposes.

Comment

All mortgage-backed security offerings that have been made to date have employed some form of credit enhancement. The fact that the list of qualifying REMIC assets does not include any form of credit enhancement other than qualified reserve funds (e.g., governmental agency guarantees, private pool insurance, letters of credit, and private guarantees) implies that credit enhancement generally is not treated as an asset of a REMIC. I.R.C. § 860G(a)(3)-(7). That implication is strengthened by the practical reality that treating third-party credit enhancement as a disqualifying REMIC asset would halt the use of REMICs.

The posting of reserve assets by a seller of mortgage collateral to secure a nonrecourse guarantee against post-sale defaults on the sold collateral serves the same function as and is a replacement for more conventional forms of third-party credit enhancement, such as insurance and governmental agency guarantees. Consequently, it should be entitled to the same treatment for REMIC purposes as other forms of third-party credit enhancement to assure that economically equivalent mortgage-backed security transactions receive the same federal income tax treatment. A collateralized seller guarantee is distinguishable from a qualified reserve fund, which is treated as being inside the REMIC, because the assets of a qualified reserve fund are provided by and owned by the residual interest holders. The assets supporting a seller guarantee, however, are neither provided nor owned by a residual interest holder (except where the guarantor also has purchased a residual interest), and the income from such assets does not flow to a REMIC interest holder except possibly through, and to the extent of, the operation of the guarantee. Consequently, it would be logical and administratively convenient to treat a collateralized seller guarantee as being outside the REMIC, but to treat a qualified reserve fund as being inside the REMIC and potentially giving rise to residual cash flow.

Treating the reserve fund securing a seller guarantee as being outside the REMIC would eliminate concerns regarding whether the seller's interest in the reserve fund creates a second class of residual interest and whether the same reserve fund may be used to collateralize guarantees relating to more than one REMIC. Such treatment also avoids the possibility that the use of collateralized seller guarantees would reduce the proportion of the REMIC's regular and residual interests that is treated as a qualifying asset for REIT and thrift institution purposes. The absence of an impact on REIT and thrift institution qualification is desirable from a tax policy standpoint in that it is consistent with the result achieved with more traditional forms of third-party credit enhancement. Finally, it should be noted that treating a reserve fund securing a seller guarantee as being outside the REMIC would not give rise to any significant potential for avoiding the qualified reserve asset requirements because (i) the rating agencies would not permit assets other than intangible investment property to be included in the reserve fund and (ii) the balance of the reserve fund would be reduced as rapidly as the rating agencies would allow.

If, for some reason, the reserve fund collateralizing a seller guarantee is considered to be inside the REMIC, the first issue to be faced is whether to treat the seller's interest in the reserve fund as a subordinated regular interest or a disqualifying second class of residual interest. The seller's interest should meet the definition of a REMIC regular interest, since it entitles the participant to a specified principal amount (the face amount of the mortgage loans or other reserve assets), and, in the case of fixed-rate assets, provides for a fixed rate of interest. Until regulations are issued permitting variable-rate regular interests, however, reserve funds containing variable-rate assets would jeopardize REMIC status since sellers could be treated as holding interests that do not qualify as regular interests. Furthermore, there is the issue of how to treat income from short- or medium-term investments of the cash flow from reserve assets pending satisfaction of rating agency requirements for release. Consequently, attempting to treat reserve assets as being inside the REMIC without giving rise to a prohibited second class of residual interest raises some complex issues, which should be resolved by regulations if the inside-the-REMIC approach is taken.

To the extent that reserve funds are treated as being inside a REMIC, guidance also is needed concerning the requirement that the reserve be reduced "properly and appropriately." That phrase should not be interpreted to dictate that the reserve must be reduced in strict proportion to the declining collateral balance. Rating agencies may require that the reserve be reduced according to some other principle. For example, a reserve fund reasonably could be structured as an amount that is fixed during the early years of the REMIC and thereafter declines under a formula based upon the prepayment experience of the sold collateral. Moreover, the rating agencies may require longer retention of assets and cash flow than otherwise would be necessary if a single reserve fund is to be used to collateralize guarantees relating to a series of CMO offerings.

Finally, the REMIC or CMO issuer clearly should be treated as the tax owner of any sold collateral that is subject to a seller guarantee because the REMIC or CMO issuer (i) has the right to dispose of the sold collateral and (ii) bears the risk of any appreciation or depreciation in the value of the sold collateral due to market fluctuations. Although the seller continues to bear the default risk, that factor is outweighed by the ownership rights that he transfers to the REMIC or CMO issuer. See Rev. Rul. 82-144, 1982-2 C.B. 34 (purchaser of tax-exempt bonds treated as tax owner of bonds despite presence of put designed to provide liquidity).

Recommendation

The regulations should clarify that private guarantees relating to uncertificated mortgage loans and any investment property securing such guarantees are not to be considered assets of the REMIC. Failing that clarification, the regulations should indicate that if the assets supporting a private guarantee are treated as within the REMIC, the guarantor's interest in the REMIC will not be considered as a residual interest. In addition, the regulations should provide that reduction of a reserve fund as rapidly as permitted by the relevant rating agency or agencies always will satisfy the requirement that a qualified reserve fund be "properly and appropriately" reduced. Finally, the regulations should clarify that a transfer of sold collateral subject only to a seller guarantee will be treated as transferring tax ownership to the REMIC or CMO issuer.

D. Partial redemption of regular interests

Issue

A REMIC generally may not dispose of a qualified mortgage at a gain without paying the 100 percent tax applicable to gain realized on prohibited transactions, except in connection with a a qualified liquidation. I.R.C. § 860F(a)(2)(A)(10). A liquidation is considered qualified if the REMIC (i) adopts a plan of complete liquidation, (ii) sells all of its non-cash assets within 90 days of the date on which it adopts the plan, and (iii) distributes in liquidation all sale proceeds plus its cash (other than amounts retained to meet claims against it) to its regular and residual interest holders within the 90-day period. I.R.C. § 860F(a)(4). Hence, a REMIC may not sell part of its qualified mortgages in order to fund the redemption of a portion of the outstanding regular interests. Moreover, since all but a *de minimis* amount of a REMIC's assets must be qualified mortgages, a REMIC may not maintain cash reserves for the eventual partial redemption of its regular interests. I.R.C. § 860D(a)(4); Conference Report at II-226. Thus, a REMIC effectively is prohibited from redeeming less than all of its regular interests, unless it may borrow or receive cash contributions for that purpose.

Comment

The vast majority of REMIC regular interests sold to date in form have resembled non-REMIC CMOs. The residual interest holders typically have been given the right to call part or all of the outstanding regular interests at specified times during the life of the REMIC. Such call rights fall into one of two broad categories: (i) "economic" call rights, which are designed to give the residual interest holders the opportunity to refinance if market interest rates decline and thus to increase the value of their interests; and (ii) "clean-up" call rights, which are designed to allow residual interest holders to avoid unduly burdensome administrative expenses by permitting redemption of the regular interests in a given class when the outstanding principal balance reaches a specified level (typically either 10 percent or 20 percent of the original balance). At present, however, considerable uncertainty exists as to whether or how a REMIC may effect a partial redemption of regular interests without engaging in prohibited transactions or jeopardizing REMIC status.

Three methods of conducting partial redemptions are possible within the existing statutory framework: (i) the residual interest holders may borrow funds and acquire directly one or more classes of regular interests, (ii) the residual interest holders may borrow funds and contribute them to the REMIC for use in retiring one or more classes of regular interests, or

(iii) the REMIC may borrow funds in its own name for the purpose of retiring one or more classes of regular interests. The same economic result for the residual interest holders could be achieved under any of the three methods.

The legislative history gives no indication why partial liquidations of REMICs are subject to unfavorable treatment. Whatever the reason, however, there appears to be no policy ground for denying REMICs the ability to redeem regular interests on a class-by-class basis. Nothing in the statute or legislative history indicates that the first method described above would interfere with the actual or intended operation of the REMIC provisions. The feasibility of the second two approaches depends upon the application of the REMIC qualification requirements. According to the statute and the legislative history, the test as to whether substantially all of the REMIC's assets are qualified mortgages and permitted investments is applied only "as of the close of the third calendar month beginning after the startup day and as of the close of every quarter of each calendar year thereafter." I.R.C. § 860D(a)(4); Conference Report at II-226. Thus, it appears that a REMIC may hold temporarily the cash necessary to exercise its partial redemption rights as long as the redemption occurs before the next qualification testing day.

Recommendation

The regulations should clarify that a REMIC may redeem a portion of its regular interests without risking REMIC disqualification or the prohibited transaction penalty tax, as long as it does not dispose of any qualified mortgages and the cash to be used in the redemption is held in the REMIC for no more than a short period of time. Specifically, the regulations should indicate that a REMIC may borrow funds or accept cash contributions from its residual interest holders, provided that the nonqualifying assets are removed from the REMIC before the next quarterly qualification testing date. The use of REMIC collateral to secure a borrowing by the REMIC should not be considered a disposition of the collateral for purposes of the prohibited transaction rules. Finally, the regulations should state that residual interest holders may purchase regular interests pursuant to a call right and may secure any necessary borrowing with their residual interests.

II. Formation of the REMIC

A. Avoidance of arbitrage gain through pre-sold regular interests

Issue

No gain or loss is recognized by the transferor on the transfer of property to a REMIC in exchange for interests in the REMIC. I.R.C. § 860F(b)(1)(A). Instead, the transferor takes a basis in the regular or residual interests received equal to the aggregate basis of the property transferred to the REMIC. I.R.C. § 860F(b)(1)(B). That substituted basis is allocated among the regular and residual interests in proportion to their respective fair market values. Id. Hence, any gain or loss inherent in the unsecuritized transferred assets that is attributable to fluctuations in market interest rates will be taxed upon the disposition of the REMIC interest received in exchange. In addition, any increase in the value of the REMIC interests attributable to their securitization ("arbitrage gain") will be subject to tax upon such disposition.

A REMIC is not required to have mortgage collateral at the time that its interests are issued. Instead, the REMIC's assets may be composed entirely of cash or other non-mortgage assets during the three-month period beginning on the startup day (generally the date upon which the offering of the regular interests is closed). I.R.C. §§ § 860D(a)(4), 860G(a)(3). When the regular interests are sold before the mortgage assets are acquired, the residual interest holder may be able to defer taxation of any arbitrage gain, since there arguably is no gain realized on the sale of the regular interests. Congress, however, apparently intended "that the step transaction doctrine would be applied so that the formation of a REMIC in the latter fashion would be recharacterized as a contribution of mortgages to the REMIC in exchange for regular and residual interests followed by a sale of all or a portion of those interests by the transferor of the mortgages." General Explanation at 417. It is unclear (i) whether the step transaction doctrine is to be applied to a "blind pool" transaction and (ii) when gain is to be recognized in a case where the mortgage assets are acquired after the sale of the regular and residual interests has been closed.

Comment

The statutory provisions allowing a REMIC three months to acquire sufficient qualifying assets to meet the "substantially all" standard provide REMIC promoters with needed flexibility. In their current form, however, they also may provide an opportunity for avoiding the recognition of arbitrage gain on pre-sold regular interests. The General Explanation attempts to close that potential loophole through the application of the step transaction doctrine. Where the promoter has either identified the precise collateral to be purchased or described with particularity a widely available type of collateral, but does not acquire the collateral until after issuance of the regular interests, the step transaction doctrine properly should apply to cause recognition of arbitrage gain at the time that the REMIC acquires the collateral. While it can be argued that the step transaction doctrine should not apply to true "blind pool" offerings (i.e., where the type of collateral to be acquired is not specified), the same rule of immediate gain recognition should govern such offerings for two reasons. First, although a true blind pool offering is theoretically possible, it is unlikely, given the current state of the CMO market, that a promoter would be able to issue regular interests in such a format. Second, the task of distinguishing a true blind pool from a transaction in which the collateral is described with sufficient certainty to make recharacterization of the transaction appropriate would lead to significant uncertainty and administrative complexity. Consequently, a uniform recognition rule would provide a simple and consistent treatment that is appropriate for the vast majority of likely offerings.

The transactional sequence that the drafters of the REMIC rules appear to have contemplated is that the promoter (i) exchanges the collateral for all of the regular and residual interests and (ii) sells the regular interests, recognizing both arbitrage gain and any market gain or loss carried over from the collateral that is attributable to the sold interests. General Explanation at 417. Transactions ordered differently should be recharacterized as having taken place in that sequence for tax purposes. Id. The amount of gain (or loss) to be recognized by the promoter would be based upon the purchase price of the collateral, regardless of whether such purchase preceded or followed the issuance of the regular interests. Because the REMIC provisions allow three months after the startup date for the acquisition of qualifying collateral, a collateral purchase could take place in the taxable year following the issuance of the regular interests. Since the amount of gain or loss would not be determined until the date of purchase (or at least until a contract of purchase is entered into), such gain or loss should be recognized in the later year.

Recommendation

The regulations should provide that a REMIC promoter who retains a residual interest will recognize gain or loss equal to the difference between the issue price of the regular interests and the portion of the purchase price of the REMIC's assets that is allocable to those interests, regardless of when such assets are acquired by the REMIC and whether the identity of the mortgage assets is specified at the time that the REMIC interests are sold.* Such gain or loss should be recognized on the later of (i) the date upon which the regular interests are issued and (ii) the earliest date upon which the amount of arbitrage gain can be determined with certainty.

B. Alternative basis determination rule

Issue

A REMIC's fair market value basis in its assets generally is to be determined on the date that it receives them (i.e., when the issuance of the regular interests is closed) or at such earlier time as regulations provide. Conference Report at II-230. Although the REMIC's "inside" basis is determined as of the closing date, the economics of an offering are fixed on the day when the offering is priced, which typically precedes the closing date by two or three weeks. Fluctuations in the value of the collateral during the period between pricing and the closing could cause the REMIC's inside basis to depart from those economics. In a footnote to the description of the inside basis determination, however, the legislative history states that regulations should "provide that the basis of qualified mortgages held by the REMIC in certain circumstances may be determined based on the fair market value of such mortgages at a reasonable time prior to transfer to the REMIC where such mortgages were purchased by the transferor solely for the purpose of transfer to the REMIC." Id. n.9 ("Footnote 9"). The language of Footnote 9 would seem to indicate that Congress considered the basis discrepancy problem and intended for regulations to remedy that problem through an alternative basis determination rule. The language of Footnote 9, however, would exclude from relief several important types of mortgage collateral.

Comment

The language of Footnote 9 is overly restrictive. By its terms, it rules out mortgages obtained by persons who did not (i) purchase the mortgages (ii) "solely for the purpose of transfer to the REMIC." Originators of mortgage loans who exchange their loans for REMIC interests always fail the first prong of Footnote 9 and often fail the second as well. Moreover, under the second prong of Footnote 9, mortgage collateral originally purchased to serve as the asset pool of another REMIC or non-REMIC CMO offering, or as a simple investment, is not eligible for the alternative basis determination rule. The restrictive terminology seems to have been inadvertent. No discernible policy reason exists for such exclusion.

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* On March 9, 1987, the ABA Section of Taxation submitted comments of members of its Committee on Sales and Financial Transactions discussing certain securities-related provisions of the Tax Reform Act of 1986 and providing recommendations for the related discussion in the General Explanation. Those comments contained a recommendation that arbitrage gain should not be recognized in a blind pool REMIC issue. For reasons described in the text, these comments of members of the REMIC task force take a different position on that issue.

Recommendation

The regulations should provide for the determination of the inside basis of REMIC assets as of the date upon which the offering was priced, regardless of whether such assets were purchased solely for the purpose of transfer to the REMIC. Overriding the language of Footnote 9 probably could be done under the Treasury's general authority to prescribe regulations "necessary and appropriate to carry out the purposes" of the REMIC provisions. I.R.C. § 860G(c). If not, a technical correction would be appropriate.

III. Taxation of Residual Interests

A. Computation of discount and premium on qualified mortgages

Issue

Prior to the passage of the Act, the Service's published position was that market discount and premium with respect to mortgage certificates and uncertificated mortgage loan pools had to be calculated using a loan-by-loan approach, rather than on an aggregate basis. Rev. Rul. 70-544, 1970-2 C.B. 6; Rev. Rul. 70-545, 1970-2 C.B. 8. Discount and premium calculations typically were based on the assumption that no prepayments of principal would occur.

The Act established a new methodology for calculating original issue discount ("OID") accruals with respect to CMOs and qualified mortgages held by a REMIC. Act § 672; Conference Report at II-238. The Act requires that the amount of market discount or premium accruing during any accrual period with respect to a qualified mortgage be computed using the same "repricing" method to be employed in determining the accrual of OID. Conference Report at II-842. At the end of each accrual period, the present value of all remaining payments on the qualified mortgage (plus the amount of principal payments received during the accrual period) is compared with the present value computed at the end of the preceding accrual period to determine the amount of discount or premium that has accrued during the period. I.R.C. § 1272(a)(6)(A). The repricing calculations are performed using the original yield to maturity of the qualified mortgage. I.R.C. § 1272(a)(6)(B).

The new statutory rules provide that the original yield to maturity computation and the repricing calculations are to be done using "a prepayment assumption determined in the manner prescribed by regulations." Id. The legislative history indicates that, in the case of CMOs, the prepayment rate to be employed in performing those computations is the prepayment rate used by the parties in pricing the transaction, which, in turn, is to be based on "the assumed rate of prepayments on qualified mortgages held by the REMIC." Conference Report at II-238. The legislative history also states that, "[i]n computing the accrual of OID (or market discount) on qualified mortgages held by the REMIC, only assumptions about the rate of prepayments on such mortgages would be taken into account." Id. n.22.

Under the new rules regarding discount and premium accrual, it is unclear to what extent accrual computations with respect to qualified mortgages may be done on an aggregate basis, rather than on a loan-by-loan basis. Furthermore, to the extent that computations must be done on a loan-by-loan basis, it is unclear whether a prepayment assumption must be determined separately for each mortgage loan and, if so, how a separate prepayment assumption for each mortgage loan is to be derived when the issuer and the underwriter have agreed to only a blended prepayment assumption for the collateral pool as a whole. Finally, it is unclear whether the new rules are to apply to mortgage collateral securing a non-REMIC CMO offering.

Comment

In a world of zero-prepayment assumptions, the Service's position that discount and premium calculations must be done on a loan-by-loan basis had little practical significance for CMO issuers. In the case of mortgage certificates, the originators or servicers of the underlying mortgage loans generally are allowed to retain any interest in excess of the coupon rate that has been established for the certificate plus a specified number of basis points to cover servicing and the credit enhancement fee. That right to excess interest income generally is referred to as "excess servicing." Consequently, under a zero prepayment assumption a certificate holder could compute discount and premium accruals on an aggregate basis because the underlying loans effectively had an interest rate equal to the coupon rate on the certificate. The variance of the gross interest rates on the underlying loans from the certificate rate, however, becomes significant when prepayments are taken into account because the likelihood of prepayments on the certificate is a function of the gross interest rates on the underlying loans.

In the case of uncertificated mortgage loan pools, it theoretically was necessary to allocate the purchase price for the pool among the mortgage loans and to keep track of which loans prepaid in order to perform the discount and premium calculations properly. As a practical matter, however, most CMO issuers either grouped loans by interest rate classes or treated the entire collateral pool as a single mortgage loan, since performing discount and premium computations for a large number of individual loans (1,000-2,000 in the case of a typical CMO offering secured by uncertificated mortgage loans) would have been a costly and time-consuming process.

The Act replaced the zero prepayment methodology with a repricing method that assumes prepayments will occur in accordance with the assumptions used in pricing the CMOs or regular interests. There are three possible interpretations of the new rules as applied to qualified mortgages: (i) all calculations may be made on an aggregate basis so that all qualified mortgages owned by a REMIC are treated effectively as a single mortgage loan with a uniform prepayment assumption; (ii) a separate discount or premium calculation must be performed with respect to each qualified mortgage (with the possibility of limited aggregation based on interest rate ranges), but a uniform prepayment assumption may be used; and (iii) separate discount or premium calculations and separate prepayment assumptions are required (with the possibility of limited aggregation where collateral items have similar interest rates and prepayment characteristics).

The third approach would make loan-by-loan calculations substantially more burdensome than under the methodology generally used prior to the Act. For example, if a REMIC offering is collateralized by 1,500 uncertificated mortgage loans that do not have uniform interest rates or maturities and loan-by-loan computations are required, the REMIC would be forced not only to keep track of computations with respect to 1,500 items of collateral, but also to assign a different prepayment rate to each loan based presumably on all the factors that were used in arriving at the pricing prepayment assumption for the regular interests. An approach that treats all items of mortgage collateral as a single mortgage loan, however, might produce significant distortions with respect to discount and premium computations under some circumstances. Nonetheless, some grouping of collateral with similar interest rates should be permitted to lower administrative costs and to make REMIC status more accessible to small issuers. Furthermore, the small amount of potential for abuse created by permitting the use of a single prepayment assumption is outweighed by considerations of administrative convenience. Consequently, the alternative that best balances tax policy and administrative concerns is the second approach modified to permit limited aggregation of collateral by interest rate class.

Finally, for the sake of analytical consistency, the same discount and premium accrual rules should apply to both REMIC and non-REMIC mortgage collateral.

Recommendations

The regulations should adopt the second approach described above and permit aggregation of all mortgage collateral that falls within given interest rate ranges (e.g., 100 basis point intervals) for purposes of computing discount and premium accruals. The regulations also should extend the new accrual rules to non-REMIC mortgage collateral.

B. Withholding tax on foreign residual holders

Issue

The 30 percent withholding tax on fixed and determinable income paid to a foreign person generally does not apply to interest paid on a debt instrument that is held in registered form, provided that (i) the instrument was issued after July 18, 1984, and (ii) the holder provides proper certification of his foreign status. I.R.C. §§ 871(h), 881(c); Temp. Reg. § 35a.9999-5(b), A-8. That exemption is referred to as the portfolio interest exemption. Interest paid on a mortgage passthrough certificate generally qualifies for the portfolio interest exemption only to the extent that the underlying mortgage loans were originated after July 18, 1984. Temp. Reg. § 35a.9999-5(e). To the extent that the portfolio interest exemption does not apply, the withholding rate still may be subject to reduction under an applicable treaty provision.

The REMIC provisions clearly indicate that the 30 percent withholding tax is imposed on REMIC taxable income that is allocable to a foreign residual interest holder and that constitutes excess inclusion (i.e., income in excess of the product of 120 percent of the applicable federal rate and the adjusted issue price of the residual interest) when such income is distributed to the holder or, if earlier, when the holder disposes of his interest. I.R.C. § 860G(b). The 30 percent rate applies regardless of whether the income otherwise would be eligible for a reduction of or exemption from withholding under a statutory or treaty provision. Id. The General Explanation clarifies that all income amounts paid to residual interest holders are to be treated as interest for purposes of the foreign withholding rules. General Explanation at 425. Furthermore, the legislative history provides that, for purposes of the portfolio interest exemption, regular interests are considered to be debt instruments issued after July 18, 1984, regardless of when the underlying mortgage loans were issued. Conference Report at II-237-38.

It is unclear whether the portfolio interest exemption is to apply to taxable income from a residual interest that is not excess inclusion (i) as though the residual interest were a newly issued debt instrument or (ii) based on a look-through to the underlying REMIC assets.

Comment and recommendation

The regulations should provide that the portfolio interest exemption applies to all taxable income from a residual interest (other than one that represents merely an undivided interest in the underlying mortgage assets) that is not excess inclusion for three reasons: (i) unlike a pass-through certificate, a residual interest generally has economic characteristics that differ substantially from those of the underlying mortgage assets; (ii) administrative convenience; and (iii) symmetry with the rule for regular interests. If, however, a look-through rule is adopted, measures should be taken to minimize the administrative problems that would arise when a REMIC holds both pre-July 18, 1984 and post-July 18, 1984 mortgage loans because the ratio between old and new loans may change whenever a prepayment occurs. For example, if a look-through approach is adopted, we would recommend that, in order to make that approach workable from an administrative standpoint, REMICs should not be required to redetermine the ratio of pre-July 18, 1984 loans to post-July 18, 1984 loans more often than annually.

C. Unrelated business taxable income

Issue

A tax-exempt entity generally is subject to federal income tax at regular corporate rates on any unrelated business taxable income ("UBTI") that it earns during a given taxable year. I.R.C. §§ 511, 512(a). Interest and discount income accruing on residential mortgage loans that are held in a tax-exempt entity's investment portfolio is not treated as UBTI except to the extent that the tax-exempt entity has incurred acquisition indebtedness to purchase the loans. I.R.C. §§ 512(b)(1), 514. The percentage of the income from debt-financed mortgage loans that is considered UBTI for any given year is based on the ratio between the average outstanding principal balance of the acquisition indebtedness and the average adjusted basis of the mortgage loans. In the case of the typical non-REMIC CMO offering that is made by a partnership or grantor trust issuer, the liability for the debt obligations issued would be treated as acquisition indebtedness for a tax-exempt investor that acquires an equity or residual interest in the issuer. The percentage of the residual income that would be treated as UBTI is extremely high (*e.g.*, initially 98 percent in the case of a 2 percent residual).

Under the REMIC provisions, excess inclusion income that is allocable to a tax-exempt holder of a residual interest constitutes UBTI. I.R.C. § 860E(b). Neither the statute nor the legislative history, however, indicates how the UBTI rules apply to non-excess inclusion income.

Comment

The first issue to be addressed is whether a UBTI determination with respect to non-excess inclusion income should be made on a look-through basis. It is possible that the assets of REMIC would produce income of a type other than interest, dividends, and capital gains. For example, some mortgage loans (typically commercial loans) might provide for contingent interest based on the net income of the mortgagor. In addition, a qualified reserve fund might contain intangible investment assets that do not produce portfolio income (*e.g.*, a limited partnership interest in a partnership that conducts a trade or business). Income of that type, however, would comprise at most a minor part of the REMIC's taxable income because of (i) the reasonableness restriction on the size of qualified reserve funds, (ii) the fact that the rating agencies normally would require that reserve funds be comprised only of debt instruments that have the same rating as the regular interests, and (iii) the risk that significant amounts of contingent interest based on net income would give rise to a nonqualifying equity interest in the property securing the qualified mortgage. Consequently, a look-through approach should be avoided on the grounds that the abuse potential is low and the potential administrative burden is great.

A second issue is whether the regular interests should be treated as acquisition indebtedness for purposes of the UBTI rules. If the regular interests were treated as acquisition indebtedness, virtually all of a REMIC's taxable income would be UBTI because residual interests typically comprise no more than 5 percent of the total value of a REMIC. Consequently, treating the regular interests as acquisition indebtedness would make the specific statutory provision relating to excess inclusion income meaningless. Accordingly, regular interests should not be viewed as acquisition indebtedness.

Recommendation

The regulations should provide that REMIC taxable income that is not excess inclusion is not to be treated as UBTI.

D. Interaction with the proportionate disallowance rules

Issue

In simple terms, the new proportionate disallowance rules trigger gain recognition with respect to a taxpayer's installment obligations based on an allocation of the taxpayer's average quarterly indebtedness among all of the taxpayer's assets, including installment obligations. I.R.C. § 453C(a)-(b). That allocation is to be done at the end of each taxable year and is to be made pro rata based on the face amount of the installment obligations and the adjusted basis of the other assets. Id. Indebtedness allocable to an installment obligation that was originated during the taxable year in question is treated as a payment received on that obligation for purposes of gain recognition. Id.

For purposes of allocating indebtedness to installment obligations, the assets and liabilities of any persons who are treated as a single employer under Code section 52 are to be aggregated. I.R.C. § 453C(e)(2). The single employer rules provide that a partnership or trust and a person who owns an interest in the partnership or trust representing more than 50 percent of the value of the entity are to be considered a single employer. Reg. § 1.52-1(c)(2). There is, of course, no reference to REMICs because section 52 and the accompanying regulations predate the Act. It is unclear whether, for purposes of the proportionate disallowance rules, the assets and liabilities of a REMIC would be aggregated with the assets and liabilities of a residual interest holder who owns more than a 50 percent interest.

Comment

The financing of mortgage loans or certificates through a REMIC structure is intended to be treated as a disposition of the mortgage loans or certificates for federal income tax purposes. It seems clear that the transfer to a REMIC of mortgage loans that are installment obligations would constitute a disposition of the mortgage loans under Code section 453B, which would trigger recognition of any deferred gain, even if the transfer otherwise could have qualified for nonrecognition treatment. It would be analytically inconsistent to treat the transfer of mortgage loans to a REMIC as a sale for installment reporting purposes, but yet to treat regular interests as indebtedness that may be aggregated with a residual interest holder's liabilities for purposes of the proportionate disallowance rules.

Recommendation

The regulations should provide that the assets and liabilities of a REMIC are not to be consolidated with the assets and liabilities of a residual interest holder for purposes of the proportionate disallowance rules.

IV. Miscellaneous Issues

A. Tax administration and reporting requirements

Issue

For purposes of federal tax administration, the Code treats REMICs as partnerships and holders of residual interests as partners. I.R.C. § 860F(e). In addition to the tax administration rules relevant only to partnerships, REMICs are subject to tax administration rules of more general application and to certain rules applying specifically to REMICs.

Under the partnership rules, a REMIC generally is required to have a tax matters partner ("TMP") to represent the REMIC as a whole for certain administrative and judicial purposes. I.R.C. § 6231(a)(7). In addition, a holder of a residual interest must file partnership tax and information returns on behalf of the REMIC and thus is responsible for making the REMIC election. Conference Report at II-230 n.10. Like any taxpayer, a REMIC must have a taxpayer identification number ("TIN"). I.R.C. § 6109. Since a REMIC is not a natural person, the appropriate TIN is an employer identification number, even if the REMIC has no employees. Reg. § 301.6109-1(a)(1). The Act requires the REMIC to report interest and OID accruals on REMIC regular interests, and shortens the list of "exempt recipients" with respect to whom interest and OID reporting is not required. I.R.C. § 6049(d)(7).

The application to REMICs of the foregoing rules is unclear in many respects. Due to the unique nature of REMICs, neither the partnership rules nor the more general rules of tax administration, including the rules with respect to interest and OID reporting, will fit REMICs properly without some tailoring.

Comment

Selection of a REMIC representative. The problems that arise in applying the partnership rules to REMICs stem from the dissimilarity between the degree of involvement of a general partner in a partnership and that of a holder of a residual interest in a REMIC. Investors who purchase residual interests typically view themselves as passive investors and look to the promoter or underwriter to perform any administrative duties relating to their investment. Consequently, the typical residual interest investor resembles a limited partner much more closely than a general partner. Thus, the performance of tax administration duties that reasonably may be expected of general partners should not be imposed on holders of residual interests who have not been involved in promoting or underwriting the residual interest offering. On the other hand, it is highly desirable as a matter of administrative convenience for the Service to be able to deal with the REMIC as an entity, through a single REMIC representative analogous to a TMP.

The REMIC representative's role could be performed more effectively by the issuer of the REMIC's regular interests or the underwriter of the residual interest offering than by a holder of a residual interest. Generally, the issuer or the underwriter (i) has a better working knowledge than any holder of a residual interest of the structure, rules, and economics of a REMIC offering and (ii) is in a much better position than any holder of a residual interest to perform the REMIC's income and expense calculations. Moreover, the issuer or underwriter has a strong ongoing interest in the REMIC's success.

Pre-election representation. Although a REMIC is a taxpayer for federal income tax purposes, many REMICs are segregated asset pools that are not entities under state law ("non-entity REMICs"). The regular interests in such REMICs typically are issued in the form of CMOs by limited-purpose finance companies that are in the business of making CMO offerings ("issuers"). Prior to the election of REMIC status on the first federal information return, it is unclear whether a non-entity REMIC has any existence as a taxpayer for purposes of performing any tax administration acts that might be necessary. Unless some provision is made for the pre-election representation of the REMIC, numerous technical difficulties are likely to present themselves. For example, like any taxpayer, a REMIC generally must include its TIN on all filings with the Service. Thus, a REMIC should apply for a TIN prior to filing its first federal information return. Furthermore, a REMIC would be required to file interest and OID reports relating to regular interests prior to filing its first federal information return. I.R.C. § 6049(c) (reports must be filed by January 31 of the year following the year in which the income is earned). However, because non-entity REMICs are not state law entities and do not become taxpayers until a REMIC election is made on their first federal information return, they may not be able to apply for a TIN or file interest and OID reports until after that return is filed, unless some person such as the underwriter or the state law issuer of the regular interests is allowed to apply on their behalf.

Reporting duties. Code section 6049 generally places reporting duties with respect to interest and OID on "persons" who pay or transmit such interest. Although all REMICs are taxpayers, non-entity REMICs should not be considered as persons for purposes of that section. Under standard industry practice, a REMIC's collateral pool is placed in trust as security for the regular interests in order to obtain a credit rating on those interests. The trustee actually receives and disburses the cash flow from the mortgage collateral. Thus, the trustee already is subject to reporting duties with respect to the REMIC's cash flows, regardless of whether the REMIC is treated as a person for section 6049 purposes. If the REMIC were to be so treated, the result would be duplicative reporting. The Conference Report, however, seems to imply that the REMIC itself should bear certain reporting duties. Conference Report at II-237.

Although the legislative history indicates that holders (presumably of both regular and residual interests) should be provided with the information necessary for the determination of OID accruals, neither it nor the statute clearly demonstrates an intent that a non-entity REMIC should be the person to provide such information. Since treating a non-entity REMIC as a person under section 6049 would provide no advantage to the Treasury, no reason exists for doing so. Nonetheless, those persons already required to perform section 6049 reporting duties with respect to non-entity REMICs (such as the bond trustee) will require the information that the Conference Report notes is most efficiently produced by the issuer or the underwriter.

The Conference Report also states that "the partnership information return filed by the REMIC is to supply information relating to the daily accruals of the REMIC." Id. at II-235. It is illogical, however, to require a non-entity REMIC to supply information to residual interest holders, if the REMIC's only representatives are the residual interest holders themselves. Once again, the persons best equipped to provide such information are the issuer and the underwriter.

REMICs that are entities for state law purposes currently are persons for section 6049 purposes. In the typical case, however, such REMICs will be mere shells without employees or in-house capacity to perform administrative functions. Thus, reporting likely would proceed more smoothly and reliably if the underwriter of the residual interests were assigned responsibility for the entity REMIC's duties under section 6049.

Generally, REMIC regular and residual interests are treated as real property loans for REIT qualification purposes, and the income on such interests is treated as interest on real property loans for those purposes, in the proportion that the REMIC's assets would have qualified if held by the REIT directly. I.R.C. § 856(c)(6)(E). If 95 percent or more of the REMIC's assets would have so qualified, the entire regular or residual interest and the income thereon is given that favorable treatment. Id. Under the statute, however, there is no requirement that information on the composition of REMIC assets be provided to holders of regular and residual interests who do not actively oversee the REMIC. That information is most readily accessible to the issuer (in the case of a non-entity REMIC) or the underwriter. Regulations imposing such a requirement could be based upon the Code's general grant of authority to the Treasury to issue regulations "as may be necessary or appropriate to carry out the purposes" of the REMIC rules. I.R.C. § 860G(c).

Recommendations

In general, the regulations should broaden substantially the role of the issuer and the underwriter in the area of REMIC administration. The underwriter or, in the case of a non-entity REMIC, the issuer should be treated as a holder of a residual interest for purposes of (i) representing the REMIC in the manner of a TMP, (ii) filing and signing the REMIC's income and information returns and making the REMIC election, and (iii) performing any other administrative functions analogous to those of a general partner in a partnership. Furthermore, the underwriter or the issuer should be authorized to represent the future REMIC prior to making the REMIC election.

With respect to section 6049 reporting and providing information to holders of residual interests, the following approach is most consistent with both the legislative history and the business realities of REMIC offerings. First, the regulations should not consider non-entity REMICs as persons for section 6049 purposes, since either the issuer or the bond trustee already is responsible for such reporting. Second, in the case of REMICs that are state law entities, the underwriter of the residual interests should be designated to perform interest and OID reporting duties on behalf of the REMIC. Third, the regulations should require the issuer or underwriter, whichever serves as the REMIC's representative, to supply holders of residual interests with the information necessary for them to report properly their share of the REMIC's income, to the extent the REMIC's federal information return is insufficient for that purpose.

Finally, the regulations should impose upon the issuer or the underwriter the additional duty of reporting the composition of the REMIC's assets to holders of regular and residual interests so that they may determine the proportion of their interests that satisfies various REIT and thrift qualification requirements.

The foregoing administrative rules probably could be promulgated under the Treasury's general authority to prescribe regulations "necessary and appropriate to carry out the purposes" of the REMIC provisions. I.R.C. § 860G(c). To the extent that the general regulatory authority is not deemed to be sufficiently broad, a technical correction would be appropriate.

B. Prohibited transactions

Issue

Section 860F(a)(1) imposes a tax on prohibited transactions without indicating the person or persons to whom the tax applies. The legislative history indicates, however, that the REMIC is required to pay the tax. Conference Report at II-230. Section 860C(b)(1)(C) excludes income from a prohibited transaction from the income of the REMIC passed through to the holders of the residual interests. The prohibited transaction tax, if interpreted to create a claim that is superior to that of the holders of regular interests, could complicate the treatment of regular interests to the point of affecting their marketability.

Comment

Assume that a qualified mortgage loan is sold at a gain in a prohibited transaction and the proceeds of the sale are distributed to the holders of regular interests and credited as a partial prepayment of those regular interests. If those holders were liable for the 100 percent tax and, in effect, had to return a portion of this prepayment to satisfy the tax, the treatment of regular interests as the investment equivalent of debt instruments or pass-through certificates would be drastically undercut. Similarly, if there is any risk that the liability for the tax would become a lien on the remaining assets of the REMIC and such lien could be prior to the rights of the holders of the regular interests, the investment quality of regular interests would be significantly reduced. By comparison, the holder of secured debt normally can expect to be repaid prior to the satisfaction of any tax lien that might subsequently attach to the property securing the debt. I.R.C. § 6323(a).

Recommendation

Liability for the prohibited transaction tax should be subordinated to the claim of the holders of regular interests. That approach is consistent with the treatment of the regular interests as secured debt for tax purposes and also reflects the economic reality that the economic benefit from a prohibited transaction, such as an impermissible disposition of a qualified mortgage loan, typically would inure only to the holders of residual interests. The subordination of the prohibited transaction tax to the claim of the holders of regular interests probably could be accomplished under the Treasury's general authority to prescribe regulations "necessary and appropriate to carry out the purposes" of the REMIC provisions. I.R.C. § 860G(c). If not, a technical correction would be appropriate.

C. Effective dates and transition rules

Issue

The REMIC and OID provisions of the Act generally became effective for taxable years beginning on or after January 1, 1987. Act § 675. Based upon the Act and the legislative history, many mortgage-backed security offerings have been sold to investors on the understanding that a REMIC election will be made with respect to such offerings. The REMIC provisions of the Act are novel and complex, however, and, as this memorandum indicates, many important issues with respect to REMIC qualification remain unsettled. A failure to meet REMIC qualification standards would have serious consequences, including: (i) loss of special status of the regular and residual interests for various purposes of thrift institutions and REITs, (ii) loss of deemed debt status of regular interests, possibly preventing the residual interest holders from deducting interest paid on the regular interests, (iii) possible double taxation of residual income, and (iv) possible liability on the part of the issuer and underwriter under federal and state securities laws.

Comment and Recommendation

Because the consequences of failing to meet REMIC qualification requirements are so severe, it is important that the regulations provide relief for offerings that were priced prior to the publication of regulations and for which a REMIC election was intended, but that fail to meet REMIC qualification standards for reasons unrelated to tax avoidance or abuse. Where such offerings were structured based upon a reasonable and bona fide interpretation of the statute and the legislative history, they should be grandfathered from the qualification requirements of the regulations to the extent that such offerings cannot be brought into conformance with such requirements without significant cost or economic detriment to the holders of regular or residual interests. Where conformance would not result in significant cost or economic detriment, the regulations should allow a reasonable period following the publication date of the regulations during which appropriate changes to the offering are to be made. During that conformance period, such REMICs should not be subject to entity-level taxation and generally should be considered as qualifying under the relevant REMIC provisions. At the close of the conformance period, any non-conforming offerings should be subject to the sanctions authorized for inadvertent terminations, I.R.C. § 860D(b)(2)(B), except in cases where (i) conformance would have resulted in significant cost or economic detriment to the holders of regular or residual interests and (ii) the failure to meet one or more of the REMIC qualification tests was based on a reasonable and bona fide interpretation of the statute and the legislative history.

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

COMMENTS ON
PROPOSED TECHNICAL CORRECTIONS ACT OF 1987

July, 1987

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

This report was prepared by members of the Committee on Foreign Activities of U.S. Taxpayers. Members of the Committee who submitted comments were Eric R. Fox, Nick D. Hansen, Dennis I. Meyer and Glenn W. White

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1. Section 112(a)(3)

Under the Tax Reform Act of 1986 ("the Act"), interest paid by a foreign subsidiary of a United States bank to its parent, which is subject to withholding tax of 5% or more, might not be treated as high withholding tax interest under the look-through rules. The problem is discussed on pages 168 and 169 of the Description of the Proposed Technical Corrections Act of 1987 ("the Bill") prepared by the Staff of the Joint Committee on Taxation ("the Description"). In order to prevent potential avoidance of the purpose of the high withholding tax interest rules, the Bill would amend section 904(d)(3) of the Code to provide that high withholding tax interest is not to be recharacterized as financial services income under the look-through rule. The Description indicates that the provision is intended to discourage banks from lending abroad through foreign subsidiaries rather than lending funds directly. Under existing law, use of a foreign subsidiary would allow the bank to convert what would be high withholding tax interest if the loan were made directly into financial services income.

The problem with the Bill's solution is that it goes too far. Financial services income consists of other types of income besides interest. Conceivably a foreign subsidiary could have a substantial amount of financial services income without having any interest income. In such a case, section 112(a)(3) of the Bill would treat any interest paid by the foreign subsidiary to the parent which is subject to withholding tax of at least 5% as high withholding tax interest even though there was a complete absence of the perceived abuse.

Accordingly, in order to limit the modification to deal with the perceived abuse, section 112(a)(3) ought to apply at most only to the extent the foreign subsidiary has interest income. Inasmuch as money is fungible, even this probably goes too far and an allocation rule would be preferable. For example, if a foreign subsidiary had financial services income of 20X of which 5X was represented by interest, and the foreign subsidiary paid interest of 4X to its United States parent which was subjected to a 5% withholding tax, 25% of the interest income, or 1X, should be recharacterized as high withholding tax interest, not the entire 4X.

2. Section 112(d)(1)

Section 112(d)(1) of the Bill is intended to resolve the conflict between the depreciation and intangible source rules by sourcing gain under the depreciation rules of section 865(c) to the extent it does not exceed depreciation claimed and sourcing all excess gain as arising under the intangible rules found in section 865(d).

In essence, the Bill sources gain, to the extent of recapture and excess gain in the form of a contingent payment, at the place where the amortizable intangible asset was used while sourcing excess gain from fixed price sales in the residence of the seller. All income from the sale of intangible property should be sourced in the county where the value of that property was generated and under whose laws the property is protected and there appears to be no basis for treating gain in excess of depreciation recapture derived from fixed price sales differently than other types of gain.

3. Section 112(d)(2)

Section 865(e) provides a special rule that sources income from the sale of personal property at the place of an office or fixed place of business if the income is "attributable" to that office or fixed place of business. In the case of residents of the U.S., this rule applies only if (A) none of the other special source rules of Code Section 865(b), (c), (d) or (f) apply (dealing with inventory, depreciable property, intangibles and stock of affiliates) and (B) a tax of at least ten percent of the income from the sale is paid to a foreign country.

Section 112(d)(2) of the Bill expands Section 865(e) to include sales of intangible property at a fixed price. One of the major beneficiaries of this change will be U.S. taxpayers that sell intangibles such as trademarks or patents associated with a foreign branch because the gain on the sale will now be foreign source if a 10 percent foreign tax is paid on the gain. In cases such as these, the recapture rule and the office rule would both produce the same foreign source result. The legislative history states that the Bill "clarifies that the recapture rule prevails over the office rule to the extent of any recapture amount." See Description at 181. This clarification is not found in the Bill but was already clear because section 865(e)(1)(A) applies currently only to the extent section 865(c) -- the recapture rule -- does not apply.

4. Section 112(d)(3)

Under section 865(g)(1), a partnership created under the laws of the U.S. is considered a U.S. resident for source purposes, and a partnership created under foreign law a non-resident. Section 112(d)(3) of the Bill changes this rule, so that source determinations will be made at the partner level, except as provided in regulations.

Although source is determined at the partner level, a U.S. office or fixed place of business of a partnership will be attributed to a foreign partner so that income from the sale of personal property attributable to that office or fixed place of business will be sourced in the U.S. See Description at 180 and section 865(e)(2)(A). It should be made clear that this attribution of an office or fixed place of business of a partnership to the partners applies in the case of foreign offices and fixed places of business as well as U.S. offices and fixed places of business.

5. Section 112(d)(4)

Under the Act, gain from the sale of stock is generally sourced in the taxpayer's country of residence regardless of the activity or place of incorporation of the corporation whose stock is sold. Section 865(f) creates a limited exception in the case of a U.S. resident that sells an 80 percent or more owned foreign subsidiary engaged in the active conduct of a trade or business if the sale occurs in the country in which the affiliate derived more than 50 percent of its gross income for the three preceding years.

For purposes of applying this limited exception, section 112(d)(4) of the Bill provides that the foreign affiliate and wholly-owned (directly or indirectly) subsidiaries of that affiliate will be treated as one corporation. This change allows a U.S. parent corporation to qualify the gain on the sale of a foreign subsidiary (a "first-tier" subsidiary) as foreign source when the subsidiary owns other subsidiaries only if those other subsidiaries are engaged in the active conduct of a trade or business in the country in which the first-tier subsidiary does business. We see no reason for this limitation.

The gain or loss on a sale of a foreign affiliate should be foreign source if the affiliate conducts an active business outside the U.S. whether or not the affiliate generates more than 50 percent of its gross income in any single foreign country. While the Act concluded otherwise, the Bill compounds this questionable result. Without the change made by the Bill, it was clear that a U.S. resident that sold a foreign affiliate under the circumstances prescribed in section 865(f) would receive foreign source income or incur a foreign source loss regardless of the stock holdings of that affiliate. Even if the Bill passes there would be no change in result if the first-tier foreign affiliate owned anything less than all of the shares of any lower tier company. Thus, the proposed rule could be avoided by establishing a small minority interest in any second-tier subsidiary.

6. Section 112(g)(2)(B)

Section 112(g)(2)(B) of the Bill excludes possessions corporations from the allocation rules of Section 864(e)(1). This result could be accomplished more directly and sensibly by modifying Section 864(e)(5)(A) to delete the parenthetical expression found in that subparagraph. If the Bill is enacted as drafted, the Code would be confusing because Section 864(e)(5)(A) would continue to include possessions corporations within the affiliated group.

7. Section 112(g)(7)

The legislative history states that the Bill clarifies the transition rules of the Act. See Description at 189. We disagree. The transitional rules of the Bill substantially reduce the transition relief provided by the general phase-in of Section 1215(c)(2)(A) of the Act.

The general phase-in rule of the Act applies to "the applicable percentage" of the taxpayer's "interest expenses" with respect to "an aggregate amount of indebtedness" which does not exceed the taxpayer's aggregate amount of indebtedness outstanding on November 16, 1985. Thus, the Act does not limit this transitional relief to the lowest amount of indebtedness of a taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985. To the extent that the Bill limits the Act's transitional relief in this manner, it clearly goes beyond a technical amendment.

We recognize that language in the Conference Report might be read to support the language of the Bill. See H. Rept. No. 99-841, 99th Cong., 2d Sess. at II-607. Nonetheless, the Act itself is clear that transitional relief applies to an aggregate amount of indebtedness outstanding on November 16, 1985, and there is no reason why a taxpayer with varying levels of debt should be treated more harshly than a taxpayer with consistent or increasing levels of debt.

8. Section 112(h)(16)

In calculating the earnings and profits of a foreign corporation, section 312 provides that LIFO, the installment method, and the completed contract method may not be used. Section 112(h)(16) of the Bill states that such methods shall be used in calculating earnings and profits for purposes of the earnings and profits limitation on Subpart F income. However, regulations are to provide that if the earnings and profits arising from the inventory assets, installment sale, or completed contracts are distributed prior to the year that they otherwise would be included in income, such earnings are not included in income in such other year.

One of the few simplifications of the 1986 Act was to eliminate the need for two earnings and profits calculations for foreign subsidiaries -- one for dividend distributions and one for Subpart F. This technical correction would again require two earnings and profits calculations, and in addition, would require complicated tracing rules for determining whether or not income attributable to the three accounting methods had been distributed prior to the year in which it was recognized for Subpart F limitation purposes. The proposed change recognizes that income of a foreign corporation should not generally be taxed earlier than it would be taxed if earned in the U.S. However, the change will introduce substantial additional complexity and administrative burden for both taxpayers and the IRS. Since it is unlikely that the change will have any revenue effect, the increased administrative burden imposed on taxpayers and the IRS far outweighs the benefits of theoretical purity and the provision should be deleted.

9. Proposed Additions to the Bill

A. Interrelationship Between CFCs and PFICs.

The Act created a special tax regime for shareholders of certain foreign corporations classified as Passive Foreign Investment Companies ("PFICs").[1] The legislative history indicates that the PFIC provisions were intended to remove the economic benefit of tax deferral and the ability to convert ordinary income to capital gain which could in some instances be obtained under prior law by U.S. investors in foreign investment funds. However, as drafted, the PFIC provisions could have the effect of terminating deferral of U.S. tax on income derived by CFCs from active business operations with respect to which Congress has specifically retained deferral. A 10 percent U.S. person shareholder of a CFC generally is subject to tax currently under section 951 in respect of the CFC's "subpart F" income which includes passive income. Thus, U.S. shareholders of CFCs derive no deferral of tax in respect of the passive investment of CFCs.

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[1] A foreign corporation is a PFIC for a taxable year if at least 75 percent of its gross income in the year is "passive income," or if at least 50 percent of its average assets (measured by value) during the year are held for the production of such income. Passive income generally includes foreign personal holding company income (as defined in section 954(c)).

In view of the above, we would recommend that an amendment be adopted providing that the PFIC provisions do not apply to 10 percent or more U.S. shareholders of CFCs.

B. Depreciation Used for the Calculation of Earnings and Profits.

The Act deleted the last sentence of section 312(k)(4), which provided that the rules of then section 168(f)(2) applied in computing the earnings and profits of foreign corporations less than 20% of whose income is derived from U.S. sources. New section 168(g)(1)(a) can be read to currently apply, and would essentially require that controlled foreign corporations use straight line depreciation over ADR-midpoint lives in determining earnings and profits. However, we believe that this point is unclear and should be clarified.

C. Non-controlled Section 902 Corporations.

Section 904(d)(2)(e) provides that dividends from each separate non-controlled section 902 corporation constitute a separate limitation basket. This provision greatly increases the number of a taxpayer's individual baskets and the complexity of its foreign tax credit limitation calculation. For example, interest and other expenses must be allocated against each such separate basket under Reg. § 1.861-8, regardless of whether or not income is received from the particular non-controlled section 902 corporation for that year. If no dividend income is received, then a loss in that separate limitation category is produced, resulting in the necessity of allocating that loss against other separate limitation baskets, and subsequently recapturing it in future years when dividend income is received.

We suggest that all dividends from non-controlled section 902 corporations be aggregated and placed in one basket. This would substantially simplify taxpayer calculations, yet would preserve the intent of the Conference Committee that foreign tax credits generated by such corporations not be allowed to be cross credited with income from controlled foreign corporations.

D. Pre-1986 Foreign Tax Credit Carryforwards.

The decision to add several new categories of foreign tax credits limitations in the 86 Act left a question as to which of the new categories would be applicable to pre-1986 Act tax credits. This was answered by new Section 904(d)(2)(I). Prior to the 1986 Act, most of a bank's foreign tax credits were subject to the overall limitation. Under the 86 Act, the foreign tax credits will generally be either financial services credits or high withholding tax credits. Due to a special transition rule, most of a bank's high withholding tax credits will also be considered financial services credits for the next 3 years. Under Section 904(d)(2)(I) a bank's foreign tax credit carryforwards will be considered financial services credits if they would have qualified as financial services credits in the year they arose. Credits not qualifying as financial services credits will be placed in the overall category in the year they arose. Since the financial services category specifically excludes high withholding tax credits, a literal reading of Section 904(d)(2)(I) would mean that high withholding tax credits that arose in 1986 would not be subject to the financial services category but most high withholding taxes credits that arise in 1987 would be included because of the special transition rules. Since virtually all of the foreign income earned by a U.S. bank will be financial services or high withholding tax income, a bank will have little chance of using foreign tax credit carryforwards placed in the overall category.

The effective prohibition on the ability to use pre-1986 Act foreign tax credit carryforwards is inconsistent with the legislative history and the apparent intent of the Conference Committee to allow banks to carryforward such credits without penalty. Under the original House bill, pre-1986 Act high withholding tax income would have been considered "banking and insurance income" and would have been allowed to offset U.S. tax on post-1986 Act "banking and insurance income". Under the Senate bill, a bank's income would have continued to be treated as overall category income and there would have been no limitation on the carryforward of pre-1986 Act date overall category credits against post-1986 Act date income.

A technical correction should be made to Section 904(d)(2)(I) allowing banks to treat pre-1986 Act overall category credits as post-1986 Act financial services category credits to the extent they would have qualified as financial services category credits in the year they arose without regard to the exclusion for high withholding tax income. This would carry out the intent of both the House and Senate bills and will avoid the anomalous results of having high withholding tax credits qualify as financial services credits if earned after enactment of the Act but not if earned before the Act was passed.

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

PROPOSED TECHNICAL CORRECTIONS TO SECTION 2035 (RELATING TO GIFTS WITHIN THREE YEARS BEFORE DEATH)

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

This report was prepared by members of the Committee on Estate and Gift Taxes. Members who participated in preparation of the report are Beverly R. Budin, Michael W. Stukenberg, Shirley D. Peterson, and Ronald D. Aucutt.

Dated: July 14, 1987

A PROPOSAL TO REMOVE A TRAP INADVERTENTLY CREATED BY THE WORDING OF SECTION 2035, AND TO SIMPLIFY SECTION 2035 BY THE REMOVAL OF "DEADWOOD"

BACKGROUND

1. Statutory History

Prior to the Tax Reform Act of 1976, Section 2035 provided that, except in the case of a bona fide sale for an adequate and full consideration in money or money's worth, transfers made "in contemplation of death" would be included in the gross estate of the decedent. Transfers made within the three-year period ending on the decedent's were presumed to have been made in contemplation of death; while transfers made prior to the three-year period were conclusively determined not to have been made in contemplation of death.

The 1976 Act modified Section 2035 by adopting a rule which provided that all gifts made by a decedent within the three-year period prior to death are included in the decedent's gross estate, with an exception for gifts which did not require the filing of a gift tax return. Thus, gifts within the annual exclusion amount would not be included in the decedent's gross estate.

In 1981 Congress revised Section 2035 by eliminating the general rule that gifts made within the three-year period ending on the date of the decedent's death would be included in the decedent's gross estate. This change was a reflection of the 1976 unification of the federal gift and estate tax systems. In general, under the unified system, property which is gifted is taxed in the same manner as property which is included in the decedent's gross estate, except that property which is gifted is valued as of the date of the gift, rather than the date of death. Thus, the elimination of the general rule of Section 2035 simply allowed gifts which were made within the three-year period prior to the decedent's death to be valued in the transfer tax base as of the date of the gift (rather than as of the date of death).

While the general rule of Section 2035 has been eliminated, Section 2035(d)(2) retains the three-year rule with respect to "a transfer of an interest which is included in the gross estate under Sections 2036, 2037, 2038 or 2042 or would have been included under any of such sections if such interest had been retained by the decedent." Thus, for example, if a decedent who has transferred property and retained a life estate in the transferred property released his life estate within the three-year period prior to his death, the gross estate would include the value of the transferred property at the time of death. The apparent statutory intent of the Section 2035(d)(2) exception is to prevent decedents from making deathbed transfers or releases of reversionary interests, life estates, incidents of ownership in insurance policies, or other powers of revocation, control or ownership in gifted property which would have a small gift tax value compared to the estate tax value (if the decedent died possessing the power or interest).

2. TAM 8609005

In TAM 8609005 the decedent created a revocable trust. The trustees had the power to distribute up to $10,000 a year to each of the decedent's children. The trustees exercised this power at the decedent's request, making gifts equal to the annual exclusion amount in each of the three years prior to the decedent's death. The Service ruled that since the distributed property would have been included in the decedent's gross estate under Section 2038 had the distributions not been made, the transfers were included in the decedent's gross estate under Section 2035(d)(2).

PROPOSALS FOR TECHNICAL CORRECTION

1. Reversal of TAM 8609005

The intent of Section 2035(d)(2) is to avoid the erosion of the transfer tax base by including in the gross estate property which was transferred within the three-year period prior to death where the gift tax value of the transfer is less than the estate tax value would have been had the transfer not been made. Typical examples are transfers of a retained life estate or transfers of policies of insurance on the life of the decedent. No purpose of the tax system is served by including in the gross estate transfers that are made from a trust which, had they been made directly by the decedent, would not have been included in the gross estate.

Section 2035(d)(2) presently is a trap for those unaware of what almost certainly is an unintended consequence of Section 2035(d)(2). Those aware of the consequence will structure their transfers in a manner which will avoid the undesired tax result, but this may involve unnecessary inconvenience.

While the situation set forth in TAM 8609005 (the revocable trust) is probably the most common situation which creates an inequitable result under Section 2035(d)(2), it is not the only one.

> EXAMPLE: A creates an irrevocable trust for the benefit of her issue, retaining the right to determine what distributions are to be made. In 1988 A directs the trustee to make distributions of $10,000 to each of her two children and four grandchildren.

In the foregoing example, as in the situation in TAM 8609005, had the transfers been made directly by the decedent, they would not have been included in the decedent's gross estate. No tax policy is served by treating the transfers differently because they were made from a trust. Attached hereto, as Exhibit "A," is a draft of Section 2035(d)(2), revised to eliminate from its scope transfers which do not fall within the tax purposes of Section 2035. Attached hereto, as Exhibit "A-1," is a draft of Section 2038, revised in a manner corresponding to the revision of Section 2035(d)(2).

2. Simplification of Section 2035

As a result of the various amendments to Section 2035, the structuring of that section is needlessly complex. The general rule of Section 2035 is set forth in Section 2035(d)(1), while Section 2035(a) was effectively revoked by Congress in 1981. Because of this ordering, anyone unfamiliar with Section 2035 will have difficulty in understanding its intent. Attached hereto, as Exhibit "B," is a draft of Section 2035, revised to (a) rewrite the section to eliminate the "deadwood" and (b) make the same revision as made in Exhibit "A."

EXHIBIT "A"

PROPOSED REVISION OF INTERNAL REVENUE CODE SECTION 2035

SEC. 2035. ADJUSTMENTS FOR GIFTS MADE WITHIN THREE YEARS OF DECEDENT'S DEATH.

(2) EXCEPTION FOR CERTAIN TRANSFERS. Paragraph (1) of this subsection and paragraph (2) of subsection (b) shall not apply to a transfer of an interest in property which is included in the value of the gross estate under section 2036, 2037, 2038 or 2042 or would have been included under any of such sections if such interest had been retained by the decedent. The preceding sentence shall not apply to any transfer from a trust unless such transfer, if made first to the decedent (whether or not this is permissible under the trust instrument) and then by the decedent, would be a transfer to which the preceding sentence would apply.

EXHIBIT "A-1"

PROPOSED REVISION OF INTERNAL REVENUE CODE §2038

SEC. 2038. REVOCABLE TRANSFERS

(a) IN GENERAL - The value of the gross estate shall include the value of all property--

(1) TRANSFERS AFTER JUNE 22, 1936 - To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the three-year period ending on the date of the decedent's death (except when such relinquishment results from a transfer from a trust and the transfer would not require inclusion in the decedent's gross estate under Section 2035).

(2) TRANSFERS ON OR BEFORE JUNE 22, 1936 - To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the three-year period ending on the date of the decedent's death (except when such relinquishment results from a transfer from a trust and the transfer would not require inclusion in the decedent's gross estate under Section 2035). Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

EXHIBIT "B"

PROPOSED REVISION OF INTERNAL REVENUE CODE SECTION 2035

(a) INCLUSION OF CERTAIN TRANSFERS IN GROSS ESTATE _ The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has made a transfer, by trust or otherwise, during the three-year period ending on the date of the decedent's death, if such transferred interest would have been included in the decedent's gross estate under section 2036, 2037, 2038 or 2042, had such transferred interest been retained by the decedent on the date of his death. The preceding sentence shall not apply to any transfer from a trust unless such transfer, if made first to the decedent (whether or not this is permissible under the trust instrument) and then by the decedent, would be a transfer to which the preceding sentence would apply.

(b) INCLUSION OF GIFT TAX ON GIFTS MADE DURING THREE YEARS BEFORE DECEDENT'S DEATH - The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under Chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the three-year period ending on the date of the decedent's death.

(c) INCLUSION OF TRANSFERS WITHIN THREE YEARS OF DEATH FOR CERTAIN PURPOSES.

(1) For purposes of Section 303(b) (relating to distributions in redemption of stock to pay death taxes), Section 2032A (relating to special valuation of certain farms, etc., real property), and subchapter C of Chapter 64 (relating to lien for taxes), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the three-year period ending on the date of the decedent's death.

(2) An estate shall be treated as meeting the thirty-five percent of adjusted gross estate requirement of Section 6166(a)(1) only if the estate meets the requirement both with and without including in the value of the gross estate the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the three-year period ending on the date of the decedent's death.

(3) The provisions of (1) and (2) above of this subsection (c) shall not apply to any transfer (other than any transfer with respect to a life insurance policy) made during a calendar year if the decedent was not required by Section 6019 (other than by reason of Section 6019(a)(2)) to file any gift tax return for such year with respect to such transfer.

(d) DEFINITION - For purposes of this section, the term "transfer" shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

COMMENTS ON THE TAX REFORM ACT OF 1986 RELATING TO FINANCIAL INSTITUTIONS

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

The comments were prepared under our direction by individual members of the committee on Banking and Savings Institutions of the Section of Taxation. Principal responsibility was exercised by Charles Wheeler, Lloyd Ator, David Grant, and James Locke. The proposals were reviewed by James S. Halpern of the Section's Committee on Government Submissions.

Technical Corrections Act Section 109

a. Amendments to Section 901 of the Tax Reform Act of 1986

i) Definition of "nonperforming loan percentage"

New Section 585(c)(3)(B)(iv) requires the computation of the nonperforming loan percentage as of the end of each quarter of the taxable year. The Conference Report at page II-329 and the Blue Book at page 552 both state that this computation is to be done "each time during the taxable year that the bank is required to report for regulatory purposes." New Section 585(c)(3)(B)(v)(I) defines non-performing loans as loans which are designated to be non-performing by the primary Federal regulatory agency with respect to the bank. Given the use of regulatory definitions and the clear statement in the legislative history that the testing is to be done at the time that regulatory reports are filed, the time for testing designated in Section 585(c)(3)(B)(iv)(I) should be changed from "the close of each calendar quarter of the taxable year" to "each time the bank is required to report for regulatory purposes." A similar conforming change should also be made in Section 585(c)(3)(B)(iv)(II).

ii) Election of Suspension Rule as Troubled Bank

New Section 585(c)(3)(B)(ii) allows a troubled bank to avoid suspending the recapture of its bad debt reserve in that 1st taxable year it is a large bank. The Blue Book, however, states that:

> A bank, that is directly recapturing its existing bad debt reserve by including an amount in taxable income, may suspend the inclusion in income of its bad debt reserve for any year in which it is a "financially troubled

> bank." Nonetheless, a financially troubled bank may elect to include in income currently all or a portion of the amount of its reserve that otherwise would be recaptured that year. Page 551-552.

A virtually identical statement is contained in the Conference Report at page II-329.

The suspension of recapture for a financially troubled bank was added by the Conference Committee so there is not a great deal of legislative history beyond what is contained in the Conference Report. It is readily apparent, however, that the provision was intended to provide relief from the recapture requirements when a bank found itself in economic trouble. Unfortunately, automatic suspension of the recapture provisions does not always provide help to financially troubled banks. Such a bank may, for example, have net operating loss carryforwards that will expire unless used currently. Suspension of the recapture rules for such a bank will prevent the offset of the NOLs by the reserve recapture. The language in the Conference Report and Blue Book cited above seems to recognize this by indicating a financially troubled bank may elect to include part or all of the recapture amount in current income. The statutory language however, appears to allow banks to avoid suspension only in the first year of the recapture period.

Section 585(c)(3)(B)(ii) should be amended to allow financially troubled banks the option of electing to suspend or not suspend recapture during any year of the recapture period.

b. Amendments to Section 903 of the Tax Reform Act of 1986

i. Blockage of NOLs

The extension of the NOL carryover period for thrifts creates a "blockage" problem with respect to a NOL incurred in 1986. For a calendar year thrift, its 1986 NOL will expire at the end of 1991. This is prior to the expiration of any NOL attributable to 1984 and 1985, which will expire at the end of 1992 and 1993, respectively. Under the ordering rules for utilization of NOLs, this could result in the 1986 NOL expiring unused.

A commercial bank may experience a similar problem. If a commercial bank has a NOL in 1987 which is not attributable to a deduction for bad debts, the NOL is carried back three years and forward 15 years. If the bank experiences an NOL in 1988 wholly attributable to a deduction for bad debts, the 1988 NOL may be carried forward for only five years. Thus, the 1987 NOL may block the use of the 1988 NOL, even though the 1987 NOL may be carried forward for nine years after the 1988 NOL expires.

The operating rules of Section 172(b)(2) should be modified to allow a NOL in the last year of a carryforward period to be used prior to other NOLs carried forward to that year but expiring in a later year.

ii) Elective use of 10 year Carryback

The Tax Reform Act placed commercial banks in the same 3 years back, 15 years forward rule for future NOLs as other corporations. The special 10 year back, 5 year forward rule was limited to NOLs arising in tax years beginning before January 1, 1987. A significant exception to this new rule was created however, for that portion of a NOL occuring in 1987 through 1993 that resulted from the bad debt deduction. New Section 172(b)(1)(L)[K] continues the 10 year back, 5 years forward rule for the portion of a NOL attributable to the bad debt deduction arising in tax years beginning before January 1, 1994. This special rule was added by the Conference Committee.

According to the Blue Book, the special rule was intended to alleviate the combined effects that the repeal of both the reserve method of accounting for bad debts and the general 10 year carrybacks rule for NOLs was expected to have on the deferred tax accounts kept for regulatory and accounting purposes. The special rule will indeed help many commercial banks that have not carried back actual NOLs to recognize the deferred tax debits.

The special provision, however, does not help banks that have had actual losses of sufficient size to wipe out all prior tax liability. These banks will not be able to use the special rule to recognize deferred tax accounts because there are no taxes to recover in the prior years. In addition, they will be prevented from utilizing the 15 year carryforward period thus potentially barring them from ever offsetting the NOL. If the special rule was intended to provide help to commercial banks, it should be made elective so that only those for whom it actually provides a benefit will use it. The election should be required to be made with the 1987 return and be irrevocable so that a bank would not be able to take advantage of the accounting benefit of the special rule until actual losses made it beneficial to switch to the general rule.

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Re: Comments on the Technical Corrections Act of 1987

Dear Rob:

I am enclosing the following comments on the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) which were prepared and reviewed by members of the Committees on S Corporations, Professional Service Corporations, Natural Resources, Tax Accounting Problems and Government Submissions.

	Subjects	Sections
1.	S Corporations	Primarily Code § 1374
2.	Uniform capitalization rule -- Mine development expenditures	TRA '86 § 108(b)(2) Code § 263A(c)(3)

The enclosed comments represent the individual views of the members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Charles

Charles W. Hall
Chair, Section of Taxation

Enclosures

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

COMMENTS ON THE TECHNICAL CORRECTIONS ACT OF 1987
H.R. 2636 AND S. 1350
PERTAINING TO S CORPORATIONS

On April 1, 1987, members of the Committee on S Corporations submitted comments on the provisions of the Tax Reform Act of 1986 ("Act") relating to S corporations. Many of our initial comments which focused on the application of the new legislation and the transitional rules have been addressed either by the Staff of the Joint Committee on Taxation's Blue Book, Internal Revenue Service ruling or pronouncement, or items contained in the Technical Corrections Act of 1987, H.R. 2636 and S 1350 ("TCA"). This second set of comments addresses certain provisions in the TCA which directly impact on S corporations and lists several items not presently set forth in the current draft for which legislative action may be required in the form of a statutory provision or appropriate reference in the legislative history.

A. Prior Application of Section 337.

Before passage of the Subchapter S Revision Act ("SSRA"), an S corporation was permitted to sell qualifying assets under section 337. In addition, Rev. Rul. 78-89, 1978-1 C.B. 272, provided that section 337 overrode the special capital gains tax provision set forth in then section 1378. When SSRA was enacted in 1982, there was nothing contained in the statute or the legislative history which specifically indicated whether access to section 337 was still available to S corporations. However, the Supplemental House Report to the Tax Reform Act of 1984 acknowledged that section 337 would continue to apply to an S corporation. H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1640. Presumably, this comment was made with full awareness of the status of the law at the time, including Rev. Rul. 78-89. Accordingly, and as directly related to Act section 631 which repeals the General Utilities doctrine, an S corporation eligible for total amnesty from the repeal of section 337, or under the transitional relief rule as a qualified corporation under Act section 633(d)(8), should avoid corporate level gain recognition where former section 337 would still apply if such corporation had been a non-electing corporation. This would also result in avoiding gain recognition under former and new section 1374, based on the principles of Rev. Rul. 78-89.

Last December the Service issued Rev.Rul. 86-141, I.R.B. 1986-49, which was directed to clear up the uncertainty concerning the manner in which a corporation may obtain relief from the repeal of the General Utilities doctrine by electing to be an S corporation. Many S corporations which meet the requirements of a qualified corporation under the Act will engage in a complete liquidation prior to 1989. Although Rev.Rul. 86-141 acknowledges that an S corporation may take full advantage of the exemption from the General Utilities repeal, or transitional relief rule under Act section 633(d)(8) as a regular corporation, no specific recognition was given to the application of section 337 and former or new section 1374. In order to remove any uncertainty as to the current status of Rev. Rul. 78-89, it is important that comment be set forth in the TCA that an S corporation will not be subject to corporate level tax under both former and new section 1374 to the extent that former section 337 or former section 336 is applicable.

B. Comparison of Former and New Section 1374.

Many corporations rushed to file S elections prior to 1987 in order to avoid being subject to new section 1374 which was enacted as a means of ensuring double taxation on asset appreciation accruing during years prior to the effective date of an S election. Based on the broader scope, purpose and applicability of new section 1374, it may have initially appeared that a corporation electing S status prior to 1987 or a qualified corporation under Act section 633(d)(5) similarly filing its election prior to 1989, will always benefit from use of former section 1374 instead of new section 1374, i.e., former section 1374 does not apply unless the net capital gain exceeds $25,000 and one-half of the S corporation's taxable income, three year versus ten year applicable period, etc. In certain situations, however, application of former section 1374 will produce greater corporate level tax. For example, former section 1374 did not limit gain recognition at the corporate level to pre-S period appreciation, as applicable under new section 1374. Instead, all gain, including post-S election appreciation, is subject to the capital gains tax. A second example involves the use of capital or net operating loss carryovers from prior C years and its interaction with former 1374. Under former section 1374, apparently section 1371(b)(1) precluded a capital loss carryover of a regular corporation electing Subchapter S from reducing a net capital gain subject to corporate level tax in the succeeding year. Furthermore, a net operating loss carryover from a C corporation year was not permitted to reduce the corporation's net capital gain in computing the more than 50% taxable income requirement. See former section 1374(d)(1). A third distinction is that former section 1374 may tax gain from the sale of a capital asset acquired after the effective date of the corporation's S election and sold within the three year statutory period.

New section 1374, in contrast to former section 1374, permits an S corporation to reduce its recognized built-in gain by net operating loss, capital loss and business credit carryforwards from C corporation years. See Act sections 632(b)(2) and 632(b)(3). Moreover, new section 1374 does not apply to asset appreciation accruing on or with respect to assets purchased after the effective date of the corporation's S election.

Although the effective dates for avoiding operation of new section 1374 set forth in Act section 632(b) and 633(d)(8) apparently are non-elective (albeit after a decision is made by a qualified corporation to elect S corporation status), it may be inequitable to impose a greater tax under former section 1374 on the sale of capital gain assets on a "relief (from General Utilities repeal)" S corporation than a "non-relief" S corporation subject to new section 1374. A more appropriate solution would be to permit "relief" S corporations to annually elect to use former or new section 1374 whichever results in a lesser amount of corporate level tax. This election should be included in the TCA as part of the transitional relief rules governing the repeal of the General Utilities doctrine.

C. C to S Conversion Tax/Definition of Predecessor Corporation.

Under new section 1374(c)(1), the special conversion tax on recognized built-in gain does not apply where the corporation has always been an S corporation. For this purpose, the statute recites that "except as provided in regulations, an S corporation and any predecessor corporation" are treated as one corporation. The use of the term "predecessor corporation" is apparently intended to have the effect that where an "always" S corporation acquires a C corporation in a reorganization, it will become subject to new section 1374. However, the scope of the corporate-level tax should only apply to the extent of the unrealized built-in gain of the assets of the acquired corporation. Consideration should also be given to a similar problem where an "always" S corporation is acquired by a C corporation by merger, with the acquiring corporation then electing Subchapter S status. The temporary C status of the acquired S corporation should not result in exposing the total unrealized asset appreciation in the S corporation's assets to a conversion tax when the acquiring corporation files its election. In short, the legislative comments to the TCA should direct the Treasury to issue regulations which carefully limit the definition of the term "predecessor corporation" in order that the scope of new section 1374 does not stray beyond its intended purpose of imposing a double tax on asset appreciation while a corporation did not have an election in effect under Subchapter S.

D. Safe Harbor Rule for Computing Recognized Built-In Gain.

As provided in new section 1374(d)(2), a corporation may reduce the amount of its "recognized built-in gain" for assets sold that were owned by the corporation as of the first day of its first taxable year as an S corporation, to the extent that the built-in gain as of such date is less than the gain recognized on the sale. In establishing a lower amount of recognized built-in gain, the corporation will have the burden of proof which will invariably require the need for appraisals, preferably obtained in close proximity to the effective date of the S election. This can be an expensive process depending on the nature and extent of the corporation's business operations. Many corporations may elect Subchapter S status without incurring the cost of an asset-by-asset appraisal, including intangibles such as goodwill and going concern value. Since a controversy over the built-in gains tax may arise after a substantial period of time has elapsed following the conversion, the failure of a corporation to carry its evidentiary burden of proof should not be used as a means of charging a corporation converting from C to S status with more corporate level tax than the statute was intended to generate. Moreover, even where an appraisal is obtained the issue may not be free from controversy since the Service is obviously permitted to question the results.

A statutory provision should be added to the TCA under new section 1374 which would permit an S corporation to use an alternative method for determining the fair market value of its assets as of the effective date of its election under section 1374(d)(1)(A) and in computing recognized built-in gain under section 1374(d)(2)(B). Such alternative method would permit an S corporation recognizing gain from an asset held on the date of conversion, to compute the unrealized appreciation subject to tax by allocating a level amount of appreciation to the asset during the entire period it was held by the corporation. The portion allocated to the period ending on the day prior to the effective date of the S election would constitute the recognized built-in gain. Similarly, the amount of any recognized built-in loss would be determined by allocating a level amount of the depreciation over the years such asset was held. This alternative method would materially reduce the costs associated with converting to S corporation status by avoiding the need for obtaining appraisals for all assets, and remove the potential for subsequent controversy and litigation on valuation questions. Despite the ability to compute gain under the proposed ratable method, a corporation should still be permitted to determine its recognized built-in gain by reference to actual values on the effective date of the conversion, which is presently the only method of valuation permitted by the statute.

E. Basis Adjustment For 1987 Short S Year Deferred Income.

Act section 806(e)(2)(C) permits a shareholder in an S corporation to take into account ratably over a four year period the excess of income over expenses for any short S year required as a result of a change in the accounting period of the corporation. Since the statute uses the same language ("taken into account") contained in section 1366(a) for items of an S corporation allocated to its shareholders, it may be argued that only the recognized portion may be added to stock basis under section 1367. Denying a full basis increase for the deferred gain will substantially diminish the previously perceived quid-pro-quo received by S shareholders (and partners) in exchange for requiring most fiscal year S corporations (and partnerships) to convert to a calendar year. If only a partial basis adjustment is allowed, the distribution of short-period profits may trigger gain in excess of basis. Partners in partnerships may be able to avoid this problem by causing their partnership to borrow funds before the end of 1987 in order to increase basis under section 752(a). However, shareholders in S corporations will have to personally borrow funds and either lend or contribute such funds to their corporation to avoid a distribution in excess of basis. Whether a full or partial basis adjustment results, additional rules regarding the acceleration of income and corresponding basis adjustments are needed in order to address the tax consequences of transfers, exchanges or sales of stock, a complete liquidation of the corporation in a subsequent year within the deferral period, or the death of a shareholder subject to the adjustment during the deferral period. Since partnerships are subject to the same taxable year conformity rule, the timing and basis adjustment rules under both subchapters should be designed to produce the same results.

Although it was previously hoped that the Blue Book would address the issue, there does not appear to be any present consensus on the correct interpretation of Act section 806(e)(2)(C). Based on the purpose behind permitting four-year averaging, the Committee is of the view that a full basis increase should be granted to a shareholder who is allocated short period income during 1987 from an S corporation (or partnership) which qualifies for four-year averaging. Accordingly, the TCA should amend Act section 806(e)(2)(C) to make a corresponding reference to section 1367(a)(1) (and section 705(a)(1)) reflecting that stock basis is to be increased by each shareholder's allocable share of short period income regardless of whether such income qualifies for four-year averaging or an election is made not to average.

F. Use of Prior C Year Capital Loss Carryforwards in Reducing Recognized Built-In Gain Under Section 1374.

The TCA specifically permits the use by an S corporation of prior C year capital loss carryforwards in reducing the recognized built-in gain imposed under new section 1374. This change is reflected by adding an additional sentence to section 1374(b)(2). The Committee welcomes this correction since the legislative history to the Act clearly sanctions the use of capital loss carryforwards as well as net operating loss carryforwards from prior C years in reducing the base of the corporate level tax. It may be helpful, however, if the computation of taxable income set forth in section 1374(d)(4), which is determined prior to reduction for net operating loss and capital loss carryovers by section 1374(b)(2), would recite that taxable income is determined "without regard to losses permitted under section 1211(a)" as it so provides in referring to section 172.

In similar fashion to C year net operating and capital loss carryforwards, a reduction in the recognized built-in gain would occur where gain from the sale of an asset used in an activity is offset by losses or deductions from prior C years which were suspended under either sections 465 (at-risk limitations) or 469 (passive activity loss limitations). A technical correction or a comment in the legislative history would help to clarify this point.

G. Statutory Definition of Recognized Built-In Gain.

1. Recognition Period Income Attributable to a Pre-S Year.

Section 1374(d)(2) defines "recognized built-in gain" as any gain recognized during the recognition period from the "disposition of any asset." In Announcement 86-128, 1986-5 I.R.B. 22, the Service stated that the term "disposition of any asset" includes the collection of accounts receivable by a cash method taxpayer, and income from the completion of a long term contract by a taxpayer using the completed contract method of accounting. Subsection (3) of the TCA section 106(f) adds new section 1374(d)(5) which confirms the Service's earlier announcement that income "properly taken into account" during the recognition period but which is "attributable to periods" prior to the C to S conversion constitutes recognized built-in gain.

The comments to the TCA should include a statement directing that the Treasury, in issuing regulations under section 1374(d)(5), to exclude work in progress and unbilled services as of the effective date of the C to S conversion from the definition of built-in gain. Accordingly, the scope of the "attributable to periods" phrase for transactions other than sales or exchanges should be limited to the right to claim or receive income, e.g., cash basis accounts receivable, completion of long term contracts, which concept was specifically identified in Announcement 86-128 and by the Staff of the Joint Committee on Taxation in its description of the TCA. The phrase "properly taken into account" in section 1374(d)(5) presumably will be construed in the regulations as referring to the period in which income is recognized under the general principles governing section 451 (relating to general rules for the taxable year of income inclusion).

2. Computing Recognized Built-in Gain Under Section 1374(c)(2)(B)/Definition of "Recognized Built-In Loss."

Section 1374(c)(2) limits the amount of recognized built-in gains which may be taken into account for any one taxable year. Such amount may not exceed the excess of the net unrealized built-in gain of all assets as of the effective date of the conversion, less the recognized built-in gains for prior taxable years during the recognition period. TCA section 106(f)(2) revises section 1374(c)(2)(B), by providing that recognized built-in gains for purposes of this limitation are only included "to the extent such gains were subject to tax under subsection (a)." Although the exact meaning of this phrase is not defined in the statute or in the Staff of the Joint Committee on Taxation's explanation to the TCA, the apparent purpose of this additional language is to reduce recognized built-in gains by the amount of previously reported recognized built-in losses. Accordingly, the TCA should set forth that for purposes of section 1374(c)(2)(B), the net recognized built-in gain for prior taxable years during the recognition period is the amount of the offset from net unrealized built-in gain under section 1374(c)(2)(A) in determining the overall limitation under section 1374(c)(2). Thus, net operating loss or capital loss carryforwards which may reduce recognized built-in gains (or taxable income) under section 1374(b)(1) do not reduce recognized built-in gain for purposes of section 1374(c)(2)(B). Furthermore, the TCA should amend section 1374(d) and define "recognized built-in loss." Presumably, such definition could be designed based on principles similar to those reflected in the definition of the identical phrase in section 382(h)(2)(B).

3. Prior S Status Before C to S Conversion.

New section 1374 applies with respect to the ten year period commencing with the effective date of a regular corporation's election under Subchapter S. Presumably this was intended to mean the date of only the most recent S election, not any previous S elections. This result should be confirmed in the TCA either by statutory amendment to the definition of "recognition period" in section 1374(d)(3) or appropriate comment in the legislative history.

H. Application of Section 1374 to Transferred Basis and Exchanged Basis Property.

1. Scope of Transferred Basis Property Provision in Section 1374(d)(7).

Although there was no specific discussion in the Conference Committee Report on the subject, the Joint Committee Staff Blue Book explained that Congress did intend that section 1374 apply to property received by an S corporation in a carryover basis transaction from a C corporation for the 10 year period commencing with the date of receipt. Similarly, S corporations subject to the built-in gains tax which receive exchanged basis property would subject the property received to section 1374 as if the corporation had continued to hold the tainted asset. See also Parts III and IV of Service Announcement 86-128, supra. Subparagraph (3) of TCA section 106(f) adds new sections 1374(d)(6) (exchanged basis) and 1374(d)(7) (transferred basis) to reduce possible areas for confusion.

As presently drafted, section 1374(d)(7) presumably covers the situation where a transferred basis asset is received by an S corporation, which is otherwise subject to a built-in gains tax, from another S corporation which was formerly a C corporation even though a literal reading of the statute indicates otherwise. In such a situation, however, full credit should be given to the transferee for the expired portion of its recognition period per new section 1374 during which the transferor corporation held the asset. Such a situation would arise, for example, if an S corporation which has been subject to new section 1374 for the preceding 9 year period (January 1, 1987 through December 31, 1995) merges into another S corporation which converted to S status more recently. In such instance, it would be unfair to impose a new 10 year holding period requirement with respect to such asset or otherwise wait until the end of the transferee's recognition period in not subjecting gain to section 1374. Instead, the preceding 9 year period should be given full credit to the transferee. Moreover, transferred basis assets received from a qualified corporation subject to former section 1374 should not subject the transferee to new section 1374 in the event of a sale or disposition. Instead, former section 1374 should continue to apply. See former section 1374(c)(3). The Committee believes it would be appropriate for the legislative history to the TCA to incorporate these comments.

2. Effective Date for Section 1374(d)(7).

The effective date of section 1374(d)(7)(by application of TCA section 119) is for taxable years beginning after 1986. However, a technical argument may be advanced that section 1374(d)(7) will not apply to an S corporation which filed its election prior to 1987. This is because Act section 633(b) provides that all amendments made by section 632(a) of the Act (which contains new section 1374) will not apply to S corporation years for which elections were made prior to 1987. Since section 1374(d)(7) was intended by Congress to apply to a pre-1987 S corporation which subsequently receives transferred basis property from a C corporation, the TCA should provide that an S corporation which filed its election prior to 1987 may later be subject to new section 1374 by operation of section 1374(d)(7) in the event it receives transferred basis property from a C corporation or S corporation already subject to new section 1374.

3. Modification of TCA Section 106(f)(3) in Defining Exchanged Basis Property.

A correction is needed to TCA section 106(f)(3) which revises subsection (d) of section 1374. In particular, new section 1374(d)(6)(B) provides that "any determination under paragraph (2)(B) or with respect to such asset" (exchanged basis property) must be made by reference to the fair market value and adjusted basis of the asset transferred as of the beginning of the corporation's first S year. Presumably, it was intended that determination under paragraph (1)(A)(relating to built-in gain) also would be made in this manner. In order to remove a possible ambiguity, new section 1374(d)(6)(B) should be amended to contain a specific reference to section 1374(d)(1) in determining net unrealized built-in gain.

I. Transfers Having a Principal Purpose of Gaining Transitional Relief Under Act Section 633(d).

Section 106(g)(4) of the TCA amends Act section 633(d)(2)(C) by providing that gain realized from an asset by a qualified corporation will not qualify for transitional relief from the repeal of the General Utilities doctrine where the basis of such asset was determined, in whole or in part, by reference to the transferor's basis provided that a principal purpose of such earlier transfer to the qualified corporation was "to secure the benefits of this subsection." The Committee is of the view that a principal purpose must not include any transfer which was effectuated in order to enable a qualified corporation to elect Subchapter S by removing a prohibited affiliation under section 1361(b)(2)(A), e.g., upstream or downstream merger between a parent and a subsidiary. The TCA, either by direct amendment to section 106(g)(4), or specific comment in the legislative history, should provide that such transfers will not trigger application of amended Act section 633(d)(2)(C).

J. C to S Conversions/Spin-Off to Elect Subchapter S.

Based on the effective date of new section 1374, i.e., elections under Subchapter S by regular corporations after 1986, many regular or C corporations converted to S corporation status by filing elections prior to 1987. For corporations in a consolidated group, conversion to S status may be accomplished by liquidating each controlled subsidiary under section 332 or by spin-off under section 355. As to the former method, the consequences to the upstream (or downstream) merger are clear and generally free of tax. One disadvantage, however, with the liquidation alternative is that the combined assets of the liquidating and distributee corporations will become subject to the claims of third parties which may have been an important business consideration in initially forming a consolidated group.

In contrast to the liquidation of a subsidiary, a division, which continues the prior segregation of subsidiary assets, must pass through several obstacles, e.g., five year trade or business requirement, non-device to distribute earnings and profits, etc. in order to result in non-recognition of gain. In the context of a C to S conversion, the business purpose requirement poses the most difficult hurdle.

It is presently uncertain whether a spin-off effectuated primarily to permit a corporation or group of corporations to elect Subchapter S will be respected by the Service as a bona fide business purpose (and not a device) under section 355. A ruling issued by the Service recognized a spin-off to elect Subchapter S in order to reduce state and local income taxes. LTR 8026068 (April 4, 1980). See also Rev.Rul. 76-187, 1976-1 C.B. 87. The Committee is of the view that there is no conceptual distinction between spinning-off a subsidiary in order to elect Subchapter S so as to reduce state and local taxes and one similarly designed to save federal corporate income taxes.

In light of the increased taxes imposed on regular corporations as a result of the Act and the repeal of the General Utilities doctrine, many closely-held consolidated groups with the aid of hindsight would have organized as brother-sister corporations and filed S elections regardless of the state income tax ramifications or other possible economic benefits from deconsolidation. Although it is debatable whether reducing federal income taxes to a corporation, which savings are enjoyed by the shareholders, is presently a sufficient business purpose under section 355, the TCA, in this limited context, should specifically sanction the ability to engage in a tax-free spin-off of a subsidiary in order to elect Subchapter S.

K. Comments to TCA Section 119.

TCA section 119 provides that the corrections made in the bill are effective as of the original effective date of the Act, which generally as to this part of the legislation, applies for taxable years beginning after December 31, 1986, unless a specific effective date within the TCA is to the contrary. Where the "corrections" in fact introduce new substantive provisions into law, retroactive application is inequitable and should be changed in the final version of the legislation. Similarly, retroactive effect should not be extended to taxpayers adversely affected by corrections which are the product of adopting positions in the Conference Report which were previously omitted from the statute, e.g., the five year holding period for shareholders owning stock in a qualified corporation.

Section of Taxation, American Bar Association
Comment on Technical Corrections Act of 1987
H.R. 2636 and S.1350
Section 108(b)
Uniform Capitalization Rules/Mine Development Expenditures

This memorandum will comment on the change which Section 108(b)(2) of the Technical Corrections Act proposes to make to Section 263A(c)(3) of the Code.

Based on remarks that Treasury personnel made last fall at the ALI-ABA/ABA Section of Taxation Course of Study on the Tax Reform Act of 1986, it was understood that the policy underlying Section 263A(c)(3) was based on the determination that "period cost" treatment should be limited strictly to domestic exploration, mine development, and intangible drilling and development cost ("IDCs") expenditures. Whether or not the decision to exclude foreign exploration and mine development expenditures and foreign IDCs from the scope of Section 263A(c)(3) was good policy is beyond the scope of this memorandum. Assuming that the policy was to limit the scope of Section 263A(c)(3) strictly to domestic exploration and mine development expenditures and to domestic IDCs, it is important to recognize that there are six provisions of the Code which govern the deduction of such domestic expenditures (either as current expense or through various methods of ratable recovery). The Tax Reform Act of 1986, in enacting Section 263A(c)(3), included a correct reference to only three of those provisions (i.e., Sections 263(c), 616(a) and 617(a)). The Technical Corrections Act of 1987 (Section 108(b)(2)) adds a reference to two more of those provisions (i.e., Sections 291(b)(2) and 59(e)). What remains missing, however, is a reference to Section 616(b).

Section 616(b) permits the deferral and subsequent ratable recovery of mine development expenditures, in much the same way that Section 59(e) permits mine development expenses, which have been deducted currently under Section 616(a), to be recovered ratably under paragraphs (1) and (2)(D) of that Section. Like Section 59(e), Section 616(b) also is elective with the taxpayer. Also, in view of the changes which the Tax Reform Act of 1986 made in the manner in which foreign mine development expenditures are treated under the Code, it is clear that, with respect to mine development expenditures paid or incurred after December 31, 1986 in taxable years ending after that date, Section 616(b) can only apply to domestic mine development expenses. (See Section 616(d)(1) of the Code and Section 411(c)(1) of the Tax Reform Act of 1986.)

If the policy behind Section 263A(c)(3) is to permit "period cost" treatment for all domestic exploration and mine development expenditures and all domestic IDCs, then clearly Section 108(b)(2)(A) of the Technical Corrections Act should be revised to include a reference to Section 616(b) of the Code.

September 10, 1987

AMERICAN CAMPING ASSOCIATION

July 15, 1987

Honorable Dan Rostenkowski, Chairman
House Ways and Means Committee
Rayburn House Office Building, Room 2111
Washington, D.C. 20515

Dear Representative Rostenkowski:

I am writing to urge you to give attention to two matters relating to the Technical Correction Act of 1987 (HR-2636).

One, I would urge you to amend that act to clarify that charitable gift annuities issued by IRC Section 501c(3) organizations are not "commercial type insurance" under IRC Section 501(m).

Individuals who use charitable gift annuities give to help charitable institutions such as the American Camping Association provide public services. Such gifts do not compete with commercial annuities. Failure to clarify the law could seriously reduce important sources of funds affecting the delivery of charitable services. Charities have received support of this type for over 100 years and this type of giving is available from many small donors who are not able to give larger amounts to charitable and remainder annuity trusts which are unaffected by this act.

Secondly, I would urge you to keep the charitable deduction in the GSTT's "inclusion ratio" formula. Repealing the GSTT charitable deduction for lead trust in the Technical Correction Act of 1987 is very far-reaching and not simply technical.

Earlier you had pledged not "to support any substantive changes to the 1986 acts couched in the form of proportedly technical amendments." This is clearly not a technical amendment, but one that is substantive in nature and I would urge you to not let it sneak by.

Thank you for your continuing leadership in these matters.

Cordially,

Armand Ball

Armand B. Ball
Executive Vice President

ABB/jhc

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COMMENTS OF AMERICAN COLLEGE OF PROBATE COUNSEL, ESTATE and GIFT TAX COMMITTEE, and EMPLOYEE BENEFITS in ESTATE PLANNING COMMITTEE, WITH RESPECT TO THE PROPOSED TECHNICAL CORRECTIONS ACT OF 1987 -- H.R. 2636

I. Section 111B(g), Amendments related to Section 1172 of the Reform Act -- Section 2057 of the 1986 Code.

The enactment of section 2057 of the Internal Revenue Code of 1986 providing for an estate tax deduction with respect to the sale of employer securities by the executor of an estate to an employee stock ownership plan ("ESOP") or an eligible worker-owned cooperative ("EWOC") creates unwarranted complexity in the administration of decedents' estates. The availability of such a deduction is difficult to justify on tax policy grounds. If Congress desires to encourage the establishment and growth of ESOPs and EWOCs there should be better methods than tinkering with the estate tax system. The Committee recommends that section 2057 be repealed prospectively only because the Committee believes that even though the section should not have been enacted in the first place, any change in a provision of the transfer tax laws on which taxpayers may have relied should not be repealed or altered retroactively to the disadvantage of the taxpayer. This position is based not only on Constitutional grounds but also on grounds of simple fairness. This recommendation of the Committee was approved by the Board of Regents of the American College of Probate Counsel at its annual meeting in February of 1987.

II. Section 111A(g) -- Section 1133 of the Reform Act -- Section 4980A (as redesignated by the Bill) of the 1986 Code.

Without intending to comment on the desirability or undesirability of the enactment of an excise tax on "excess distributions from qualified retirement plans," it is clear that section 4980A, as enacted by section 1133 of the Reform Act, requires considerable technical correction, especially with respect to the operation of the additional estate tax provided under section 4980A(d) if the tax is to be administerable. While many of the problems have been corrected under the Technical Corrections Bill, not all have and we believe that some of the amendments made by the Bill require clarification or correction as follows:

1. Mitigation of Double Taxation -- The regular estate tax provisions should be amended to provide for a deduction from the gross estate for the amount of any additional tax imposed by section 4980A(d). If the decedent had received all of his distributions during his lifetime, the amount of the 15% excise tax on such distributions would have resulted in the reduction of the taxpayer's gross estate as a result of such tax payments or the existence of a liability therefor on date of death. Since the obvious purpose of the additional estate tax under section 4980A(d) is to equalize the liability with respect to a taxpayer who dies before receiving all of the excess distributions, equal treatment requires the allowance of

a deduction of the excise tax for regular estate tax purposes. The allowance of such a deduction under section 2053 would appear to be a more appropriate provision for the mitigation of double taxation than the allowance of a deduction for income tax purposes under section 691(c) as indicated by the Joint Committee on Taxation explanation of the Reform Act.

2. Spousal Election -- The provisions of section 111A(g)(5) permitting a spousal beneficiary to defer the imposition of the additional estate tax by treating the decedent's interests and any retirement distribution attributable to such interests as if such interests were the spouse's is a great improvement, eliminating a number of the cash flow and marital deduction problems created by the section as originally enacted. However, the requirement that no one other than the spouse receive more than a de minimis portion of the interests (with the term "de minimis" meaning one percent according to the Joint Committee Staff explanation), may create an unnecessary trap for the unwary. The interests of the Treasury would appear to be equally served by imposing the additional estate tax on any amounts, however large, received by persons other than the spouse. To accomplish this, it would be only necessary to subtract (i) the amount of tax which would be imposed if the deferred excess retirement accumulation had been taxed as the sole excess retirement accumulation from (ii) the tax which would be imposed if there were no deferral. Thus, the government would be receiving the incremental tax which would be caused by the portion going to persons other than the spouse, and would later receive the balance of the tax if, as and when the spouse received distributions or died.

3. Date of Grandfathering -- The use of August 1, 1986 as the grandfathering date will raise administrative problems for many plans. In order to apply the grandfathering election, as the statute is currently worded, affected plans will have to be valued, and allocation procedures followed with respect to the accrued benefits of plan participants, as of August 1, 1986. In the experience of the members of the committee, very few, plans are likely to have procedures established for valuing plan assets and making allocations as of that date, thus requiring a plan fiduciary to institute a special valuation and allocation procedure simply for purposes of the grandfathering election. Such special procedures may, in many instances, be burdensome and expensive to implement as compared with using the normal valuation date for the plan, or at least a valuation date which is likely to coincide with that followed by many plans or to be relatively convenient to implement. To this end, amending the Code to provide a base date for the grandfathering election of December 31, 1986, would be much more consistent with the accounting and valuation procedures followed by most plans. A possible convenient administrative alternative might be to permit an election to use the closest normal valuation date utilized by the plan for normal administrative purposes. Any potential for abuse which may have been perceived at the time this provision was initially considered has, of course, been eliminated by the passage of time.

4. Qualified Domestic Relations Orders -- Further clarification is needed with respect to the interplay of the grandfather election rule with qualified domestic relations

orders. Is the grandfathered amount required to be allocated between the participant and his or her spouse on some proportionate basis, or could, for example, all of the grandfathered portion be awarded to the spouse?

III. Section 114(f) -- Amendments related to Section 1431 of the Reform Act -- Chapter 13 of the 1986 Code.

Again, without commenting on the desirability as a matter of tax policy of the enactment of chapter 13 of the Internal Revenue Code, it is the opinion of our Committee that assuming the desirability of such enactment there is great need for technical correction of the provisions as enacted by the 1986 Reform Act, and further technical correction with respect to the provisions contained in H.R. 2636, although it is also the opinion of our Committee that H.R. 2636 has made a number of needed corrections. A number of the members of our Committee are also members of committees of the Section of Taxation and of the Section of Real Property, Probate and Trust Law of the American Bar Association, which committees are also submitting comments. To the extent that those comments are not inconsistent with the separate specific comments made herein, we would endorse the comments of those committees. The fact that these comments do not specifically address any issue under chapter 13 of the Internal Revenue Code should not be construed as an indication that our Committee endorses the existing provisions.

1. Support Obligations -- The provision of section 114(f)(7) of the Bill adding section 2652(c)(3) to the 1986 Code is desirable. However, if it is intended to avoid creation of a trap for the unwary in the drafting of instruments, it may not achieve its intended result. It is subject to the interpretation that a broad encroachment provision in a trust instrument permitting use of trust funds for the "health, education, support or maintenance of a beneficiary" would constitute as an express provision for satisfaction of the obligation of support, even though the possibility of the use of the funds to satisfy such obligation would be so remote as to be negligible. A better solution might be to have the consequence depend upon actual use of funds of the trust for the proscribed purpose.

2. Gifts to Existing Trusts -- Clarification is needed in the computation of the applicable fraction where a partially non-taxable gift is made to an existing trust. While the proper interpretation of the provisions of section 2642(d) should be to include in the denominator of the fraction only the taxable portion of the gift. Any possible contrary interpretation could easily be eliminated by amending section 2642(c)(2)(A) adding at the end thereof the words "or subsection (d)(2)(B)."

3. Payment of Estate Tax with respect to Elective QTIP -- The Technical Corrections Act of 1987 does not deal with a question that has been bothering a substantial number of estate planners with respect to what constitutes an addition to an exempt trust for generation-skipping transfer tax purposes. The precise situation arises where an allocation of a portion of the generation-skipping transfer tax exemption is made to a

qualified terminable interest property trust and provision is made to pay the federal estate tax attributable to the qualified terminable interest property trust being included in the estate of the surviving spouse from the surviving spouse's other assets so as to preserve the generation-skipping transfer tax exemption to the extent that it has been allocated to the "QTIP trust." The payment of the federal estate tax attributable to the qualified terminable interest property trust should not constitute a constructive addition to the trust which is otherwise exempt from generation-skipping transfer tax.

4. Single Trust not to be treated as Multiple Trusts -- The effect of the addition by section 14(f)(15) of the new sentence (which is arguably more than a technical correction) at the end of Section 2654(b) is of much broader scope than the annual exclusion problem addressed by the Joint Committee Staff in its description of this provision. Not only will this require grandparents to establish separate trusts for their annual exclusion gifts and strictly limit the value of the gifts to the exclusionary amount, but it will in many cases require the creation of multiple testamentary trusts for purposes of an effective allocation of the $1 million exemption. The result may be to preclude authorization for the subdivision of generation-skipping trusts and the allocation of the exemption so as to produce one wholly exempt trust and one wholly taxable trust, thereby putting a premium on complicated drafting and increasing administration costs through the use of multiple trusts of a smaller size. On the other hand, if the donor or testator chooses not to use multiple trusts, this provision will create administrative nightmares for the trustee.

IV. Section 114(g) -- Amendments related to Section 1433 of the Reform Act.

1. Effective Date Changes -- Our Committee strongly opposes the provision of section 114(g)(2)(D) which retroactively changes the effective date insofar as persons who were competent on September 25, 1985 but became incompetent prior to October 22, 1986. The provision of the Tax Reform Act of 1986 was perfectly clear that a person who had executed a Will prior to the date of enactment and was incompetent to change the same on the date of enactment and at all times thereafter would not be subject to the tax by reason of provisions in such Will. This provision was included in the original Bill, H.R. 3636, so that any individual knowledgable about the provisions of the Bill would have been lead to believe that he would have until the date of enactment to change the provisions so as to avoid the imposition of the generation-skipping tax. Changing the words "on the date of enactment" to "September 25, 1985," in paragraph (2) of §1433(b) is extremely inequitable since, as a practical matter, no one could know for certain what would happen in the generation-skipping transfer tax area until the statute was actually enacted, so that a person who was not incompetent on September 25, 1985, but became incompetent before the date of enactment on October 22, 1986, would be penalized for not revising a Will or a funded revocable trust in anticipation of legislation which might not have ever been enacted had the Senate version of the Tax Reform Act of 1986 been adopted. The

retroactive effect of such a provision is of questionable constitutionality. In addition, there seems to be no justification for the disparity in treatment in this regard, or persons who died before January 1, 1987, even if they changed their Wills between September 25, 1985 and October 22, 1986, and those who were incompetent but had the misfortune of living beyond January 1, 1987, notwithstanding that such person's incompetency occurred after September 25, 1985 and before October 22, 1986.

2. Grandchild Exemption -- In section 114(g)(3) of the Bill, dealing with the $2 Million Grandchild Exemption the Bill would provide three statutory standards to qualify a trust for the benefit of a grandchild as a transfer "to" such grandchild. One of the standards -- the requirement that, after the grandchild reaches age 21, the trust must pay all income currently to the grandchild -- seems unnecessary from the point of view of giving the grandchild a vested interest and undesirable from the point of view of limiting a grandparent's legitimate planning objective to give the trustee discretion over distributions of income and principal to the grandchild during the continuance of the trust. The two other statutory requirements -providing that the grandchild be the exclusive beneficiary and that trust assets be estate tax includible -- should be sufficient. Especially in the establishment of trusts for beneficiaries of tender years, sound policy would dictate that income distributions be left to the determination of a trusted person that the beneficiary is sufficiently mature to handle the funds. Such maturity may not be reached at age 21 in many cases. With the compression of income tax rates for trusts under the Reform Act, there is already a tax incentive to make income distributions. The decision of the grandfather or grandmother to postpone income distributions will be non-tax oriented.

If the income distribution requirement is retained, it should be retained only for transfers after the date of enactment of the Bill. It should be noted that the Instructions to the Form 709 United States Gift (and Generation-Skipping Transfer! Tax Return Rev. January 1987), issued by the Department of the Treasury, Internal Revenue Service, contained the following instruction which is inconsistent with this requirement and which might well have misled taxpayers:

> "If you transferred real property to your grandchild in trust, you may only claim a grandchild exclusion if the property transferred will be included in the grandchild's gross estate for Federal estate tax purposes. For example, this requirement is satisfied if you gave your grandchild a general power of appointment over the property transferred to a trust."

3. Grandfathered Instruments -- Section 114(g)(2) of the Bill would properly equate a revocable trust to a Will by grandfathering "transfers under" either form of instrument executed before date of enactment if the decedent died before January 1, 1987. The Bill still does not adequately deal with the situation where the decedent created a QTIP trust under either a Will or revocable trust signed before date of

enactment but died prior to January 1 leaving a surviving spouse. The Bill should be further clarified to provide that the QTIP (including one over which the surviving spouse has a limited testamentary power of appointment) will be treated as a grandfathered "transfer under" either form of instrument. In the absence of clarification, there would be considerable uncertainty as to the application of the various Chapter 13 rules regarding the identity of the transferor (e.g., Section 2652(a) of the Code, Section 114(f)(10) of the Bill), valuation (e.g., Section 2642(b)(4) of the Code) and partial grandfathering of trust assets (Section 114(g)(3) of the Bill adding Section 1433(b)(4)). If there is no clarification on the point, the decedent's personal representative would seem to be in the anomalous position of deciding whether it is necessary to make an election under Section 2652(a)(3) -- an election which arguably should not be available to him by reason of the wording of Section 1433 -- to treat the decedent as the transferor of the QTIP for grandfathering purposes.

4. Definitions for Section 1433(b)(3) of the Reform Act -- Our committee believes that the new Section 1433(b)(3) proposed by Section 114(g)( ) of the Bill should be changed by changing the semi-colon to a period and deleting the portion thereafter. There is no reason why the definition of a grandchild of the transferor, for purposes of the predeceased child exception for purposes of Section 1433(b)(3) should not be identical. Transfers to the grandchildren of the transferor's spouse or former spouse should be included as those eligible for the application of Section 1433(b)(3) particularly in view of the fact that the provision sunsets on January 1, 1990.

V. Additional Technical Corrections in The Treatment of Transfers of Plan Benefits Between Spouses.

A. The law should be clarified or amended to permit an effective "Transfer" of an Employee's interest in Plan Benefits for State Law purposes

1. The Problem. Section 401(a)(13) and the Retirement Equity Act inhibit the ability of a spouse (particularly a nonemployee spouse in a community property state) to transfer an interest in qualified plan benefits in a manner which is effective for state property law purposes. Both provisions contain exceptions for transfers which are made pursuant to qualified domestic relations orders ("QDROS"), defined under Section 414(p).

2. QDRO Definition. Section 414(p) defines the terms "domestic relations order" and "qualified domestic relations order" in such a way as to make it unclear whether a probate order otherwise meeting the requirements of Section 414(p) constitutes a QDRO. The section should be amended to make it clear that such probate orders do, in fact, constitute QDROs so that upon the death of a spouse it would be clear that the spouse could transfer his or her interest in plan benefits in the same manner that other property is transferred.

3. The QDRO rules prohibiting cashouts of over $3,500 should be relaxed for probate QDROs, so that the beneficiary of a deceased nonemployee spouse's estate can elect to receive whatever benefit is allowed under the employee spouse's plan following the nonemployee spouse's death in a community property state.

B. The Marital Deduction

Section 2056 should be amended to make it clear that any benefit under a qualified or nonqualified plan, IRA or other retirement arrangement may qualify for the federal estate marital deduction treatment. Furthermore, Section 2056 should be amended to make it clear that an interest in such benefits passing (presumably pursuant to the type of probate QDRO discussed in the proceeding paragraph) from one spouse to another will qualify in full for the deduction at the first spouse's death, and that any residual amount remaining in the plan or IRA at the surviving spouse's death will be included in such spouse's estate in the same manner as is currently provided with respect to qualified terminable interest property under Sections 2056(b)(7)(B) and 2044. Amendments to this effect would probably be required in both Sections 2056 and 2044. Such clarification should also address the valuation of the marital deduction at the first spouses death. For example, the Internal Revenue Service currently uses a 10% discount rate for valuing benefits paid in annuity form, based on the amount of the initial payment, so that if payments increase over time, the full marital deduction may not be available to the first spouse's estate. This is particularly true since a surviving spouse is not required to begin receiving payments until age 70-1/2 under Sections 401(a)(9)(b)(iv) and 408(d)(3), may elect to receive payments over his or her life expectancy (recalculated annually), and will in most cases have a relatively long life expectancy. Under the Proposed Regulations §20.2056(b)-7(c)(2) and 7(e), Examples 8-10 and 12-14, certain types of distribution arrangements to a surviving spouse will not qualify in full for the marital deduction. In short, the calculations made with respect to the marital deduction under Section 2056 should be made on the same basis as the income tax requirements under the other sections of the Code. Finally, Section 2056 should be clarified to the effect that an interest in qualified or nonqualified plan benefits, or an IRA, passing to a surviving spouse will not be deemed a terminable interest, regardless of the form of benefits elected. If for example, in a community property state, the interest of a nonemployee spouse were to pass to the employee spouse under a probate QDRO, it should be clear that the interest will not be a non-qualifying terminable interest even though the interest may be subject to, e.g., the rights of a surviving second spouse under the Retirement Equity Act.

C. Gift Tax Issues

The Tax Reform Act of 1988 repealed Section 2517 and enacted Section 2503(f), both of which dealt with the gift tax implications of benefit payments from qualified plans. The Retirement Equity Act of 1984 had previously imposed a requirement that most retirement plans provide for a joint and survivor annuity form of benefit for any married participant. The participant may have the ability to waive such joint and survivor annuity, as long as the participant's spouse consents to the waiver. Section 2503(f), added by the Tax Reform Act of 1986, clarifies that such a waiver, and in particular the consent to such a waiver by the nonemployee spouse, will not constitute a transfer for gift tax purposes. Unfortunately, this section does not address the reverse situation--what happens when a participant retires and does not waive the joint and survivor annuity requirement (or the spouse does not consent)? Prior to the Tax Reform Act of 1986, Section 2517 made it clear that where a participant receives a smaller annuity during his lifetime to enable his spouse to receive a survivor annuity, the election to do so would not, in general, constitute a gift. The repeal of Section 2517 causes the surviving spouse's interest in a joint and survivor annuity from a qualified plan to be a taxable gift. The internal Revenue Service has issued a number of rulings in a similar context dealing with the Civil Service Retirement Spouse Equity Act of 1984, including private letter rulings 8639075, 8647004 and 8708008. In each instance, the Service has taken the position that the "gift" of the value of the survivor annuity did not qualify for either the annual exclusion or the marital deduction.

The anomalous result produced by the repeal of Section 2517 and the enactment of Section 2503(f) is that, from a tax standpoint, married participants will be encouraged to waive the joint and survivor annuity and to persuade their spouses to consent to such waivers, in order to avoid making a transfer subject to the gift tax at retirement. In all likelihood, this is precisely the opposite result from that which was intended by Congress in enacting the Retirement Equity Act of 1984 and Section 2503(f). This matter should be corrected so that, at a minimum, the "gift" which occurs when a participant does not waive the joint and survivor annuity (or the nonemployee spouse declines to consent) qualifies in full for the marital deduction. This is a matter which probably should be addressed in connection with Section 2523, dealing with the gift tax marital deduction. The College would suggest that a provision be added similar to that now found in Section 2523(d) dealing with the creation of joint interests, to the effect that any retained interest of the donor in the joint and survivor annuity which exists by virtue of the fact that the donor's spouse (the participant) may survive the donee spouse will not be deemed to be an interest retained by the donor for himself.

VI. Technical Correction of Sections 2035 and 2038 of 1986 Code to clarify Congressional intent as contrary to result of Technical Advice Memorandum ("TAM") 8609005.

In 1986, while the Reform Act was pending, the Service issued a TAM holding that a gift made from a lifetime revocable trust within three years would be brought back under section 2035 into the grantor's estate for estates tax purposes even though a similar gift made by the grantor directly would not -- a triumph of form over substance. A revocable trust is merely an alter ego for the grantor. It normally is and should be treated no differently for income, gift and estate tax purposes than if the assets of the trust were owned outright by the grantor without any trust. It is only a method of providing for convenient management of property during life and as a substitute for probate. TAM 8609005 should be overruled legislatively. The correction could be made simply by adding the following parenthetical clause at the end of section 2035(d)(2) of the 1986 Code:

> "(except under sections 2036, 2037 and 2038 with respect to a transfer from or a release of any interest in or power over a revocable trust)."

with a corresponding modification adding at the end of the first sentence of each of Sections 2038(a)(1) and (2)the following:

> "(except a transfer from or a release of any interest in or power over a revocable trust)."

A more detailed memorandum of the problem created by the TAM 8609005 and the proposed solutions is available on request.

THE AMERICAN COLLEGE OF PROBATE COUNSEL
FIDUCIARY INCOME TAX COMMITTEE

Comments With Respect To
H.R. 2636, A Bill To Enact The
Technical Corrections Act Of 1987

A. Section 101(f)(3); amendment of Section 67(e) of the 1986 Code with respect to determination of adjusted gross income in the case of estates and trusts.

The Fiduciary Income Tax Committee of the ACPC supports this section of the Bill. We understand that the section has given rise to some controversy, and, therefore, believe it is useful to articulate our support of the provision.

Section 67 of the 1986 Code provides that miscellaneous itemized deductions are subject to a floor of 2% of adjusted gross income. The rule also applies to estates and trusts, although subject to a special exception for certain administrative expenses.

Under the existing law, if both the estate or trust and a beneficiary to whom distributions are being made have miscellaneous itemized deductions of the type subject to the 2% floor, the disallowance under Section 67 will be greater than the disallowance would have been if the income and deductions of the estate or trust and the beneficiary had all belonged to a single taxpayer. The reason for this result is that where distributions are made to a beneficiary, the adjusted gross income of the estate or trust which is taken into account in applying the 2% floor at the fiduciary level is, with minor adjustments, also taken into account in determining the beneficiary's 2% floor, since the beneficiary will include in his gross income under Section 652 or Section 662 of the 1986 Code distributions of estate or trust income.

Section 101(f)(3) of the Bill cures this problem by amending Section 67(e) of the 1986 Code to provide that the distributions deduction under Section 651 and Section 661 of the 1986 Code will be applied in determining the adjusted gross income of an estate or trust. Accordingly, to the extent that a distributions deduction is available under Section 651 or Section 661, the income which is passed out to the beneficiary will not be taken into account in determining the 2% floor at the estate or trust level.

This is a very practical solution to the potential double disallowance problem.

To the extent that any questions may arise with respect to the allocation of miscellaneous itemized deductions between a beneficiary and an estate or trust, it is to be noted that Section 101(f)(4) of the Bill amends Section 67(c) of the 1986 Code by granting the Secretary of the Treasury regulatory authority which appears to be broad enough to permit allocation of such deductions among estates and trusts and their beneficiaries.

B. Recommended technical correction to clarify application of Section 674(c) of the 1986 Code where grantor's spouse is a co-trustee with an independent trustee.

Section 674(a) of the 1986 Code provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus of the income therefrom is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party.

Section 674(c) of the 1986 Code provides an exception to Section 674(a) with respect to "... a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor - [to make certain distributions and payments] ...." (Emphasis added.)

For purposes of applying Section 674(c), it is not clear whether the exception applies where the spouse of the grantor is a co-trustee with an independent trustee. It would appear that a technical correction is necessary to clarify that "none of whom is the grantor" should be construed to include "none of whom is the grantor's spouse."

It is to be noted that Section 114(a)(2) of the Bill would amend Section 675 of the 1986 Code to clarify that a loan to a grantor's spouse would be treated as a loan to the grantor. The absence of a similar technical correction with respect to Section 674(c) might give rise to a negative implication that having the spouse of a grantor act as trustee was not intended to be the equivalent of the grantor acting as trustee.

In order to be consistent with the apparent intention of Congress that a grantor's spouse will be treated as the grantor for all purposes connected with Subpart E, it is recommended that Section 674(c) of the 1986 Code be amended to add the words "or the grantor's spouse (within the meaning of Section 672(e)(2))" after the words "... none of whom is the grantor."

C. Recommended technical correction with respect to interest on pecuniary bequests.

In general, income earned on assets of an estate or trust is taxable only once. If no distributions (other than distributions subject to the exclusions of Section 663(a) of the 1986 Code) are made from an estate or complex trust to beneficiaries during the taxable year, such income is taxable to such estate or trust. To the extent distributions are made to beneficiaries during the taxable year, such estate or trust is entitled to a distributions deduction under Section 661 and the beneficiary takes in income under Section 662 of the 1986 Code. In effect, the taxable income is allocated between the taxpayers but is taxed only once.

Where payment of a pecuniary bequest is delayed, the laws of some states provide that the legatee is entitled to "interest" on the delayed payment. In Rev. Rul. 73-322, 1973-2 CB 44, the Service ruled that such statutory interest was truly interest and was not subject to the application of the distributions deduction under Section 661. This result had limited economic effect in 1973, since the estate was entitled to an interest deduction which compensated for its loss of a distributions deduction.

However, with the advent of limitations to the deductibility of interest under the Tax Reform Act of 1986, late payment of pecuniary legacies may result in double taxation of income if relief is not provided by technical corrections.

The income earned on the assets which are the subject of the pecuniary legacy will be taxable to the estate, but the estate will receive no interest deduction for the payment of such "interest" to the legatee, unless such interest can be characterized as "investment interest" under Section 163(h)(2)(B) of the 1986 Code or some other exception to the definition of "Personal Interest" under Section 163(h)(2) of the 1986 Code. Nevertheless, the legatee will pay tax on the "interest" received.

Since late payment of pecuniary legacies is often necessary (*e.g.*, because of open estate tax issues), estates with pecuniary bequests may be subject to higher income taxes than estates limited to residuary bequests, and the deductibility of payments will vary state to state depending upon whether, and the extent to which, such statutory interest is imposed.

A similar result might obtain in the case of a revocable trust which is used as a will equivalent, or in the case of some other form of trust, such as a QTIP trust, which is required to make pecuniary distributions on the death of the decedent or the decedent's spouse.

To correct this problem, it is recommended that a new subparagraph (F) be added to Section 163(h)(2) of the 1986 Code, to read as follows:

> "(F) any amount payable as interest by an estate or trust by reason of delayed payment of any bequest, legacy, or other required distribution."

D. Recommended technical correction with respect to treatment of Section 67 of the 1986 Code upon termination of estates and trusts.

During the administration of an estate or trust, deductions for costs which are paid or incurred in connection with the administration of the estate or trust, and would not have been incurred if the property were not held in such estate or trust, are deductible from gross income in computing adjusted gross income pursuant to Section 67(e) of the 1986 Code. These costs are accordingly not subject to the 2% floor on miscellaneous itemized deductions.

On termination of an estate or trust, to the extent that deductions (with minor exceptions) for the last taxable year of the estate or trust exceed gross income, such excess is allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust pursuant to Section 642(h) of the 1986 Code.

While there appears to be no reason for such excess deductions to be treated differently in the hands of beneficiaries than in the hands of the estate or trust, there is need for clarification with respect to Section 67 treatment of such deductions in the hands of beneficiaries who succeed to such deductions under Section 642(h).

It should be noted that if relief is not provided by technical corrections, executors may be forced to match these costs against estate or trust income by prepaying fees or commissions in years prior to termination or by extending the period of administration in order to maximize estate or trust income. One result may be an increase in controversies over whether administration of an estate has been unduly prolonged (See Regs. § 1.641(b)-3(a)).

It is recommended that a new subparagraph (14) be added to Section 67(b) of the 1986 Code, to read as follows:

> "(14) the deduction under section 642(h) (relating to excess deductions on termination of an estate or trust) to the extent that excess deductions allowable to beneficiaries under that section
>
> > (i) consist of deductions for costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such estate or trust, or
> >
> > (ii) consist of deductions excepted from the definition of "miscellaneous itemized deductions" under subparagraphs (1) through (13) of this section 67(b)."

E. Recommended technical correction with respect to unused passive activity losses and credits on termination of estates and trusts.

Section 642(h) of the 1986 Code allows beneficiaries succeeding to the property of a terminated estate or trust to succeed to unused loss carryovers and excess deductions. It would seem appropriate and consistent with the legislative history to have the same treatment apply with respect to suspended passive activity losses and credits.

It is recommended that Section 642(h) be amended by adding the word "or" at the end of clause (2), deleting the balance of such subsection and substituting therefor the following:

> "(3) for the last taxable year of the estate or trust disallowed passive activity loss or passive activity credit under subsections (a) or (b) of section 469,
>
> then such carryover or such excess or such disallowed passive activity loss or passive activity credit shall be allowed as a deduction or passive activity loss or passive activity credit, in accordance with regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust."

F. Recommended technical correction to make the treatment of revocable trusts consistent with the treatment of estates with respect to estimated taxes.

For state law and other administrative reasons, many practitioners use revocable trusts as "will equivalents" in estate planning. Where a trust is fully revocable by the grantor at the time of his death, there appears to be no policy reason to treat the revocable trust differently than an estate after the grantor's death with respect to estimated taxes.

It is recommended that Section 6654(l) of the 1986 Code be amended to read as follows:

> "(l) Estates and Trusts. -- This section shall apply to --
>
> (1) any trust other than a trust, after the death of the grantor, which was revocable by the grantor at the time of his death, and
>
> (2) any estate, and any trust, after the death of the grantor, which was revocable by the grantor at the time of his death, with respect to any taxable year ending 2 or more years after the date of the decedent's or the grantor's death."

G. Section 114(d)(3); amendment of Section 643(g) of the 1986 Code with respect to payments of estimated tax treated as paid by beneficiary.

Section 643(g)(2) of the 1986 Code provides that the election of a fiduciary to treat excess estimated tax payments as being made by the beneficiary must be made on a return filed on or before the 65th day after the close of the taxable year.

Section 114(d)(3) of the Bill amends Section 643(g)(2) to provide that the election must be made on or before the 65th day after the close of the taxable year, but not necessarily on a tax return.

The proposed technical correction fails to address the major problem of the statute, namely that 65 days will often not be enough time for the fiduciary to analyze whether, and to what extent, an election should be made.

While it is true that 65 days is the time provided by statute for making distributions which may be considered as having been made on the last day of the preceding taxable year under Section 663(b) of the 1986 Code, it is not a sufficient time for a fiduciary to finalize the fiduciary income tax computations necessary to make an intelligent election under Section 643(g) of the 1986 Code. The Section 663(b) election is based primarily on a computation of income, which should be easily determinable within the time frame. The Section 643(g) election, on the other hand, requires a final computation of the fiduciary income tax, which will include consideration of such complex issues as alternative minimum tax, income and deductions with respect to passive investments, and income and deductions with respect to partnerships and other entities which may not have provided the estate or trust with sufficient tax information within the time frame.

It is recommended that in lieu of the amendment proposed in the Bill, Section 643(g)(2) of the 1986 Code be amended to read as follows:

> "(2) TIME FOR MAKING ELECTION. -- An election under paragraph (1) shall be made only on a timely filed return of the tax imposed by this chapter for the taxable year."

Further, there seems to be no reason why an estate should not be entitled to use Section 643(g) once it is subject to payment of estimated taxes.

It is recommended that Section 643(g)(1) of the 1986 Code be amended to read:

> "(1) IN GENERAL. -- In the case of a trust, or in the case of an estate with respect to any taxable year ending two or more years after the date of the decedent's death --"

Conforming amendments should be made to substitute "trustee or executor" wherever "trustee" appears.

In the event that the Code is amended to provide that revocable trusts will be treated in the same manner as estates in that they will be subject to estimated taxes only with respect to taxable years ending two or more years after the grantor's death, further conforming amendments should be made.

STATEMENT OF
THE AMERICAN COUNCIL OF LIFE INSURANCE
ON THE PROVISIONS OF
H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987
JULY 17, 1987

The American Council of Life Insurance urges that the following three issues be resolved in the technical corrections to the Tax Reform Act of 1986:

1. Transition rule for market discount bonds. H.R. 2636 would revise the capital gains transition rule for market discount bonds held by life insurance companies to make it applicable to all life insurance companies at a 31.6% tax rate. The ACLI strongly supports adoption of the generic approach to a transition rule but urges that the tax rate be lowered to 29.1%.

2. Alternative minimum tax. It is urged that a technical correction be made to the corporate alternative minimum tax provisions to clarify that certain exceptions applicable under the normal income tax computation as respects corporate-owned annuities also apply in computing the adjusted current earnings preference.

3. Non-discrimination requirements for group-term life insurance plans. It is urged that a technical correction be added, if deemed necessary, to make clear that the two long standing methods for structuring employee contributions to group-term life insurance plans will continue to qualify under the new non-discrimination rules for these plans in Section 89.

In each case, a supporting memorandum is attached.

GENERIC CAPITAL GAINS GRANDFATHER CLAUSE FOR MARKET DISCOUNT BONDS HELD BY LIFE INSURANCE COMPANIES-- TAX RATE SHOULD BE NO HIGHER THAN 29.1%

Summary of Proposal: The technical corrections bill (H.R. 2636) would expand the scope of the capital gains grandfather clause for certain market discount bonds in the Tax Reform Act of 1986 to cover all life insurance companies, instead of only a limited group of 15 companies. (Section 110(a)(2) and (3)) However, the grandfathered tax rate would be increased from 28% to 31.6%, on the grounds that this increase is necessary to achieve revenue neutrality. In fact, the tax rate for this expanded provision should be set no higher than 29.1%, since at that rate, budget receipts and deficits in the February baseline would be unaffected. Thus, it is urged that the technical corrections bill be amended to reduce the expanded capital gains grandfather clause tax rate to 29.1%.

Background: The Tax Reform Act of 1986 repealed the corporate capital gains tax rate of 28% and subjected such gains to tax at the new 34% corporate ordinary income tax rate.

However, as part of its transition rules, Congress decided to allocate amounts to a grandfather clause with respect to the capital gains tax rate for market discount on existing bond portfolios held by life insurance companies (and previously grandfathered under the 1984 legislation). At the time this transition rule was being considered last fall, it was estimated that the revenue cost of a full grandfather clause (i.e., one preserving the prior 28% tax rate) for all life insurance companies would significantly exceed the amount that could be allocated to this rule. Thus, it was decided to enact a 28% provision applicable to only 15 life insurance companies.

It was estimated at that time that the cost of a transition rule for those companies would equal $120 million over the 5-year revenue estimating period. Therefore, the grandfather provision was carried in the Conference Report as a reduction of budget receipts of $120 million over the 5-year period; and it continues to be carried at that level in the February budget baseline.

The revenue estimates used in connection with the grandfather provision were, of necessity, made very quickly and based on information hurriedly compiled by a limited number of life insurance companies. In order to update the revenue figures to reflect bond sales at the end of the year and make them as accurate as possible, the ACLI, early in 1987, conducted a special survey of member companies requesting information as to market discount in bond portfolios held on December 31, 1986. The results of this survey were given to the staff of the Joint Committee on Taxation. On the basis of this updated information and its own analysis, the Joint Committee staff now estimates that the transition rule, if applied on an industry-wide basis at a 28% rate, involves a revenue loss of $146 million for the relevant 5-year estimating period.

This revised estimate is only $26 million more than the amount Congress originally agreed to spend on this issue and the amount which is carried in the February budget baseline. A generic transition rule at a 29.1% rate would produce a revenue loss equal to the original

$120 million figure and would have no effect on budget receipts and deficits using the February baseline. This budget neutrality would only be threatened if the Congressional Budget Office reflects a revised estimate of the revenue cost of the grandfather provision when it updates the budget baseline in August.

Position: On the basis of this updated information, the market discount transition rule provided by the 1986 Tax Reform Act should be corrected to apply on an industry-wide basis at a 29.1% rate. The technical corrections bill achieves such industry-wide application but should be amended to lower the tax rate to 29.1%.

Such a transition rule is important for all life insurance companies holding market discount bonds. The gain to be realized on a market discount bond is known and fixed at the time of purchase. The after-tax value of that gain is, in turn, often used by life insurance companies in setting investment returns or in pricing contracts it enters into with customers. A grandfather provision is needed to protect existing market discount bonds from a change in the tax rate which could retroactively turn good business decisions into bad decisions.

Moreover, an industry-wide provision at a 29.1% rate would be consistent with the revenue and budget effects of the 1986 Act. As indicated, Congress originally allocated $120 million to a capital gains transition rule for market discount bonds of life insurance companies and this amount is reflected in the February budget baseline. Based on current data, a 29.1% generic provision conforms to the $120 million figure, and, therefore, would have no additional impact on budget receipts and deficits against this baseline.

The Joint Committee staff estimate of $146 million for a generic provision at 28% is made up of two components: $59 million is attributable to maintaining the current 15-company provision and $87 million is attributable to expanding the grandfather clause to apply to the remainder of the life insurance business. It has been indicated by the Staff that, to achieve revenue neutrality, the total revenue cost of a generic rule must be limited to $59 million, the current estimate of the cost for the 15 companies. According to the Staff, this can only be accomplished, in the context of a generic grandfather clause, by providing a tax rate of 31.6%, instead of 28%. This undoubtedly is the genesis of the provision in the technical corrections bill.

What this analysis ignores is the budget effects of the alternatives. As indicated, a 29.1% generic grandfather tax rate would have no additional budget impact over that presently included in the February baseline for a capital gains grandfather provision.

Proposed Amendment: In subparagraph (B) of Section 110(a)(2) of H.R. 2636, strike out "31.6 percent" and insert in lieu thereof "29.1 percent".

TAXATION OF INCOME ON CORPORATE-OWNED ANNUITIES UNDER THE CORPORATE ALTERNATIVE MINIMUM TAX

A new corporate alternative minimum tax was enacted as part of the Tax Reform Act of 1986. A "business untaxed reported profits" preference item was included to reach untaxed corporate income. The preference consists of a book income adjustment for taxable years beginning in 1987, 1988 and 1989 and of an adjusted current earnings adjustment thereafter.

Section 56(g)(4)(B)(iii) of the Code relates to the computation of adjusted current earnings. The provision includes in adjusted current earnings the income build-up on annuity contracts held by non-natural persons. The includible income is determined under Section 72(u)(2).

Section 72(u), also enacted as part of the 1986 Act, includes in the regular tax base the inside build-up on annuity contracts held by non-natural persons. The primary target of this provision was deferred compensation arrangements. To focus the legislation Section 72(u)(3) contains five exceptions to the general rule. These exceptions are for annuities held generally in a fiduciary capacity for another, such as annuities to fund pension plans and terminated pension plans. It was recognized that in such nominal capacity the holder normally receives no gain other than any otherwise taxable fee. (It is recognized that an immediate annuity under Section 72(u)(3)(E) could involve relatively minor amounts of economic income.)

As noted, Section 56(g)(4)(B)(iii) cross-references Section 72(u)(2) concerning income determination. However, the provision does not make clear that the exceptions in Section 72(u)(3), mentioned above, should be taken into account for adjusted current earnings purposes.

Accordingly, we urge inclusion of a technical correction to make clear that the Section 72(u)(3) exceptions apply with respect to the income to be included in adjusted current earnings under Section 56(g)(4)(B)(iii). This could be accomplished by changing the reference in Section 56(g)(4)(B)(iii) from Section 72(u)(2) to Section 72(u) with appropriate Committee report language.

The new corporate alternative minimum tax provisions were clearly intended to impose a minimum tax only on economic gain -- on corporate income not otherwise taxed. The proposed Technical Corrections Act of 1987 (H.R. 2636) already recognizes that the income on annuities held by a corporate employer in a fiduciary capacity for its employees should not be taxed to the employer under Section 56(g)(4)(B)(iii). (Section 107(b)(12)) This technical correction proposal applies to annuity contracts held by a corporate employer under Section 403(a) plans and corresponds to the part of the Section 72(u)(3)(B) regular tax exception that concerns a corporate holder of an annuity.

Building on this provision, the rest of the Section 72(u)(3) exceptions should also be excluded from the alternative minimum tax base. The other annuity contracts in those exceptions either do not involve a corporation holding an annuity (Section 72(u)(3)(A)), concern an immediate rather than a deferred annuity (Section 72(u)(3)(D)), or involve a corporation holding an annuity as a fiduciary. Those latter two exceptions are discussed further below.

Section 72(u)(3)(D) provides an exception, similar to that in Section 72(u)(3)(B)(iii), for deferred annuities held by the employer for the employees' benefit where they are purchased to fund the accrued obligations to employees under a terminated plan. The trustee of the plan being terminated must provide for these obligations of the plan. The purchase of dedicated deferred annuity contracts is the presently required means of funding such obligations. The existing contractual arrangements do not entitle a company to recover, from any source in the transaction, income tax it may be required to pay on the income on these annuities held for the employees' benefit.

The income from a structured settlement annuity (Section 72(u)(3)(C)) is also contractually dedicated to the benefit of the injured party. In structured settlements all distributions from the annuity received by the annuity holder administering the settlement must be paid to the injured party. Section 130, concerning such settlements, requires the payments under the annuity contract to match the required payments to the injured party.

We understand that the National Structured Settlement Trade Association is requesting the same correction. The ACLI fully supports their views that without clarification, injured parties who enter into settlement arrangements will be adversely affected.

Quite clearly the corporate holder of these deferred annuities does not share in or benefit from the income build-up on the annuities that are held for others. If Section 56(g)(4)(B)(iii) is not clarified, companies will revise their contracts so that the burden of the tax will fall on the beneficial owners of the annuity contracts, that is, on the employees or the injured parties.

The alternative minimum tax provisions are intended to include in the base for the tax economic income not included in the regular tax base. While somewhat ambiguous Section 56(g)(4)(B)(iii) appears to include the income attributable to contributions made to annuity contracts prior to March 1, 1986. That income is excluded from the coverage of Section 72(u). The income from the corporate-held annuities included in the exceptions under Section 72(u)(3) are excluded from the regular tax base. Since such income generally does not represent economic income to the corporate holder, it should also be excluded from the alternative minimum tax base.

GROUP-TERM LIFE INSURANCE PLANS -- EMPLOYEE CONTRIBUTION FORMULAS

Summary of Proposal: It should be made clear that the Section 89 non-discrimination testing rules, as added by the Tax Reform Act of 1986, accommodate both of the common contributory group-term life plan designs -- the "flat-rate" plan and the age, or "step-rate", plan.

Problem:

There are two very common group-term life contributory plan designs: (1) the age or "step" rated plan, where the rate of employee contributions is tied to age related premium brackets; and (2) the flat plan, where each employee pays the same amount per thousand dollars of coverage. These formulas have been in existence for many years, are widely used by employers, and were not in any way developed to deal with the peculiarities of non-discrimination testing for group-term life insurance. In this regard, it might be noted that the Federal Government's plan uses the flat contribution approach.

For reasons discussed in more detail below, each of these contribution approaches is consistent with long standing life insurance principles and neither should, in and of itself, cause a group-term life insurance plan to fail the non-discrimination tests. In order to assure that both approaches may pass the Section 89 non-discrimination requirements, it appears two aspects of the rules need to be clarified:

(1) Under the "step-rate" plan, employee contributions vary based on age. However, at each step, the employer is paying for the same percentage of each dollar of coverage. Thus, each separate contribution "step" should not be considered to give rise to a separate plan -- with arbitrary and potentially adverse consequences under the 50% eligibility test of Section 89(d)(1)(B) and its alternative, Section 89(d)(2).

(2) The "flat-rate" plan, by contrast, involves employee contributions that do not vary although the actual cost of the insurance protection increases with age. This plan design also should not be considered to give rise to a series of separate plans even though the employer contribution at each age level represents a different percentage of the actual cost of the coverage. If differing levels of employer provided benefit were assumed, a flat-rate plan could face severe testing problems under not only the 50% eligibility test but also the 90/50 test of Section 89(d)(1)(A) and the Section 89(e) benefits test as well.

Discussion:

Section 89 is designed to police benefit discrepancies that are based on compensation status. The two contributory plan formats described above are designed to deal with a factor that has nothing to do with high- vs. low-pay status -- that is, the increasing cost of life insurance at older ages. Both formats deal with this factor in accordance with traditional insurance principles.

In the flat plan an employee pays a level premium over the duration of his or her coverage rather than bearing an increasingly greater cost as that employee grows older. This follows the traditional individual whole life insurance model. The step-rate plan is more akin to the model of traditional individual term insurance where the individual's cost increases with age. Both designs represent an acceptable way to provide for the increasing cost of life insurance -- and both should be accommodated in the Section 89 testing scheme.

In order for Section 89 to accommodate both approaches to group-term life funding, two clarifications via technical correction may be needed:

1. A first step would be to clarify that a plan involving employee contributions that vary based on age will not, for that reason alone, be disqualified for treatment as a "single plan" for purposes of applying the Section 89 test.

2. A second step would be to clarify that the "employer provided benefit" provided under each of the two common contributory plans be measured in a manner that makes sense for that plan. Thus, in the "step-rate" plan, where employee contributions are based on actual cost, the portion of the total benefit that is "employer provided" should also be determined by looking at actual cost. In the "flat" plan, where employee contributions are based on an averaged, constant rate, the portion of the total benefit that is "employer provided" should similarly be determined by looking at an average, constant, cost -- for example, the Table I rate at age 40.

These clarifications would result in both formats for employee contributions being treated as a single plan. This would permit the two common contributory plan designs to be tested under Section 89 without distortions created by the chance dispersion of high and low compensated at various age levels.

American Farm Bureau Federation

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July 23, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski:

In response to the Committee's request for comments on H.R. 2636, the Technical Corrections Act of 1987, Farm Bureau appreciates the opportunity to discuss two issues which are raised with regard to the technical corrections package. While these points do not relate directly to the provisions of the bill, they do relate to the Tax Reform Act of 1986. We believe that they warrant the Committee's examination, particularly since there may be no other appropriate forum for their consideration in this session of Congress.

PREPRODUCTIVE PERIOD EXPENSING

The Tax Reform Act of 1986 made a major change in the way expenses are recovered for producers who raise replacement stock for their livestock herds. Under the old law, producers could expense the costs of raising such livestock in the year the expenses were incurred. The new law requires that these expenses be capitalized if the preproductive period is two years or longer. An election can be made to use expensing, but all assets used in the farming operation must use straight line depreciation rather than more favorable depreciation methods and expensed costs must be recaptured upon disposition of the animal.

We believe that the new capitalization and election provisions are unworkable. The record keeping associated with allocation of the expenses of raised livestock are unwieldy as producers attempt to separate the costs of raising livestock (some of which will be replacement animals) from the allocation of expenses for other animals which will not be placed in the herd.

Another major question for which no answer seems to exist is the length of the preproductive period. How is it determined? From conception until a heifer is placed in the breeding herd? From the birth of the animal until placement in the breeding herd? In addition, we question whether the recapture associated with the expensing election is necessary particularly since capital gains treatment is no longer permitted.

DEDUCTIBILITY OF HEALTH INSURANCE COSTS OF THE SELF-EMPLOYED

The Tax Reform Act of 1986 allows a 25 percent deduction for health insurance premiums of self-employed taxpayers between 1987-89. The deduction will be allowed only if the coverage is provided under one or more plans meeting the new fringe benefit nondiscrimination rules. As a result, it appears that employees will have to be covered under an employer-provided health insurance plan.

As written, this provision causes problems because it is doubtful that many self-employed taxpayers, especially farmers, furnish health insurance to their employees. The cost of such employee benefit plans is prohibitive to many farmers, particularly since many farmers themselves do not carry health insurance because of extremely high premiums.

In fact, we have reservations about the move in Congress to mandate certain employee benefits. The costs of these programs could push even more farmers over the brink by increasing costs associated with farm labor.

While the dialogue of mandated benefits will be lengthy, we urge the Committee to look specifically at this time at the health insurance deduction for self-employed taxpayers and to remove the restrictions that will discourage its use by self-employed farmers and ranchers. We remind the Committee that the provision, which originated as a 50 percent deduction with no time limit, was watered down significantly in conference to 25 percent over a three-year period. In fact, Farm Bureau supports a deduction for the full cost of health insurance premiums as a business expense.

We appreciate the Committee's consideration of our comments about the need for annual expensing of preproduction period costs rather than capitalization, and a workable and expanded deduction for the health insurance costs of self-employed taxpayers. We would be pleased to provide you with other information should you desire it.

Sincerely,

John Datt

John C. Datt
Executive Director
Washington Office

JCD/lh

AMERICAN INSURANCE ASSOCIATION

1025 Connecticut Ave., N.W.
Washington, D.C. 20036
(202) 293-3010

15 July 1987

Mr. Robert Leonard
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, DC 20515

Dear Mr. Leonard:

The American Insurance Association (AIA) is submitting for your consideration comments with respect to three items we believe should be included in the Technical Corrections Act of 1987, H.R.2636 and S.1350 (Bill). The first item relates to the impact of discounting loss reserves on complying with the requirement to make estimated tax payments under section 6655 of the Internal Revenue Code. The second item relates to the determination of earning and profits of a controlled foreign insurance corporation. And the third item relates to the treatment of same country risk insurance income.

The AIA represents 170 stock property casualty insurance companies, which write multiline coverage throughout the United States. Their combined premiums in 1985 represented more than 25% of the property casualty insurance premiums in the United States.

We appreciate your consideration of our comments and would welcome the opportunity to discuss them further with the Committee staff.

Sincerely,

C. Michael Gilliland

C. Michael Gilliland
Tax Counsel

EDWARD H. BUDD
CHAIRMAN
DeROY C. THOMAS
CHAIRMAN ELECT
ROBERT J. HAUGH
VICE CHAIRMAN
WILSON H. TAYLOR
VICE CHAIRMAN
ROBERT E. VAGLEY
PRESIDENT

ITEM ONE: THE EFFECT OF DISCOUNTING ON ESTIMATED TAX

Section 6655 of the Internal Revenue Code requires, with certain exceptions, that corporate estimated tax payments equal or exceed 90% of the tax shown on the return for the taxable year or suffer penalties and interest. Section 6655 lists a number of exceptions to this general rule. The exceptions include one for last year's tax (Section 6655(d)(1)); one for annualized monthly or quarterly income (Section 6655(d)(2); and one for seasonal income (Section 6655(e)).

While these exceptions provide some degree of protection to property casualty insurance companies against the variance between discounting estimates and the exact calculation after preparation of Schedules O and P, the protection is not complete and the variance could be considerable. Schedules O and P are not generally available until February of the year following the tax year. Also, the first quarter results by line cannot be made available for an April 15th estimate, even if quarterly Schedules O and P are produced.

The most reasonable solution to this problem would be to allow a property casualty company to use its preceding year's rate of discounting in calculating its estimated tax. This number is known or computable on the date of the first estimated tax installment and, absent a dramatic expansion of business, should not produce a material overpayment of estimated tax.

Recommendation

Section 6655 of the 1986 Code should be amended by adding subsection (f) and renumbering the current subsections (f) through (i).

"(f) ADDITIONAL EXCEPTION FOR CERTAIN INSURANCE COMPANIES -

(1) IN GENERAL. - Notwithstanding the preceding subsections, the addition to tax with respect to any

underpayment of any installment shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceed 90% of the amount determined under paragraph (2).

(2) DETERMINATION OF AMOUNT. - The amount determined under this paragraph for any installment shall be determined in the following manner -

(A) determined the taxable income for the taxpayer without regard to any deduction for discounted unpaid losses (as defined in section 846);

(B) deduct all unpaid losses on life insurance contracts plus all adjusted discounted unpaid losses outstanding at the end of the taxable year and add unpaid losses on life insurance contracts plus all adjusted discounted unpaid losses outstanding at the end of the preceding taxable year; and

(C) determine the tax on the amount determined under subparagraphs (A) and (B).

(D) adjusted unpaid discounted losses as of the end of any taxable year shall be determined by multiplying the the amount of undiscounted unpaid losses (as defined in section 846) at the end of such taxable year by the discounted unpaid losses at the end of the preceding taxable year and dividing the result by the undiscounted unpaid losses at the end of the preceding taxable year.

(3) ESTIMATED TAX FOR TAXABLE YEARS BEGINNING IN 1987

(A) No addition to tax and no interest shall be payable for any period prior to March 15, 1988 on any underpayment of tax to the extent that such underpayment was created by the discounting of unpaid losses in a ccordance with section 846."

(B) Effective Date.

(1) IN GENERAL. - The amendments made by this section shall apply to taxable years beginning after December 31, 1986.

ITEM TWO: EARNINGS AND PROFITS OF A CONTROLLED FOREIGN INSURANCE CORPORATION

Section 112(h)(6) of the Bill provides that for purposes of computing the earnings and profits limitation on Subpart F income, current earnings and profits are determined without regard to the increase in earnings and profits under section 1023(e)(3)(C) of the Tax Reform Act which provides that the fresh start amount attributable to discounting of loss reserves is added to 1987 earnings and profits. We support section 112(h)(6) of the Bill and further believe that the same rule should apply to the determination of earnings and profits for purposes of arriving at the deemed paid foreign tax credit under section 902. Otherwise, this one-time addition to earnings and profits resulting from "fresh start," which was intended as a relief provision for domestic companies will artificially reduce the deemed paid credit associated with the Subpart F income of controlled foreign insurance companies.

Recommendation.

Section 112(h)(6) of the Bill should be amended to read as follows:

> "For purposes of applying section 952(c)(1)(A) and section 902(c)(1) of the 1986 Code, the earnings and profits of any corporation shall be determined without regard to any increase in earnings and profits under section 1023(e)(3)(C) of the Reform Act." (new language underscored)

ITEM THREE: SAME COUNTRY RISK INSURANCE INCOME

Section 1221(b) of the Tax Reform Act eliminated deferral from current U.S. taxation for income attributable to insurance of risks outside the country of incorporation of the controlled foreign corporation (CFC). This was accomplished by amending the definition of insurance income in section 953. In addition, section 1221(a)(1) of the Tax Reform Act repealed the exclusions from foreign personal holding company income previously contained in section 954(c)(3)(B) and (C) of the 1954 Code for dividends, interest and gains from sale or exchange of stocks or securities derived from investment by an insurance company of its reserves and a portion of its surplus.

The amendments to section 953 and 954 taken together have been interpreted as preserving deferral only for underwriting income attributable to risks arising within the same country of incorporation of the CFC. (See, General Explanation of the Tax Reform Act of 1986 prepared by the staff of the Joint Committee on Taxation at 976-977.)

The active trade or business of insurance consists of both underwriting and investment income. This is one integral business and the same policy reasons which support retention of deferral of same country risk underwriting income apply equally to investment income related to same country risk business. Further, in the typical case an insurance company is experiencing an underwriting loss which is offset by investment income. Thus, if the same country risk provision is to be meaningful and not illusory, it is necessary to provide deferral for both investment and underwriting income.

A technical correction is needed to clarify that the investment income attributable to same country risk insurance business is entitled to deferral. As was the case under prior law, this can be accomplished by an amendment to the definition of foreign personal holding company income under section 954(c).

This technical amendment would not provide possibilities of abuse or manipulation. Insurance companies are regulated by the countries in which they do business and are required to maintain reserves and surplus by these local jurisdictions. In addition, the statutory language which we are suggesting would only preserve deferral for investment income attributable to same country risk business.

There is one further item related to the definition of non-same country risk insurance income which we also suggest be addressed as part of technical corrections. There are circumstances in which a U.S. shareholder corporation will have a controlled foreign corporation establish a branch in another foreign country rather than establish a separate controlled foreign corporation. For example, there are capital requirements and other regulatory advantages within the European Economic Community (EEC) if an EEC company rather than a U.S. company establishes a branch in another EEC country. The same tax policy reasons for preserving deferral for same country risk insurance income would apply to the insurance income of the branch related to risks arising in the country where the branch is located. This result could be achieved by treating the branch as if it were a separate foreign corporation created or organized under the laws of the country in which the branch is licensed.

Recommendation

Section 954(c) of the 1986 Code should be amended to provide that:

> Foreign personal holding company income shall not include income derived by an insurance company from the investment of (1) its unearned premiums, (2) reserves ordinary and necessary for the proper conduct of its insurance business, (3) an amount of its assets equal to one-third of its premiums earned on insurance contracts (other than life insurance and annuity contracts), and (4) in the case of a life insurance company, an allocable portion of surplus determined under principles consistent with section 813 of the Code. This paragraph is to apply to the extent these items of income are not included in insurance income under section 953(a).

Section 953(a) of the 1986 Code should be amended by adding a new Subparagraph:

> (3) For purposes of this section, a branch of a controlled foreign corporation licensed and predominantly engaged in the insurance business in a foreign country, shall be treated as a separate controlled foreign corporation created or organized under the laws of the country in which the branch is licensed.

BeaverCollege
OFFICE OF THE PRESIDENT
(215) 572-2908

July 29, 1987

The Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Sir:

I am writing in response to the call for public comment on H.R. 2636, the bill to correct elements of the Tax Reform Act of 1986. That Act contained several provisions which, perhaps inadvertently, threaten to have a severe impact on private higher education. I am heartened to learn that the House is considering refinements in the tax code which will remove these threats to the already delicate financial circumstances of private colleges and universities. Several of the specific issues before Ways and Means are of particular concern to us.

The first concerns the conflicting interpretations now possible when considering the tax status of scholarship aid to students. If it is possible to consider such aid taxable when it involves service by the student such as teaching or research, the net result would be to tax directly the academic practice of requiring such activities as part of a student's program. Moreover, to levy such a tax would strike most inequitably at those least able to afford it: the students who are putting together several sources of aid in order to afford a college education. At Beaver over 100 undergraduates have some work-related scholarship (nearly one out of six of our students). These are often students whose families' earnings alone are not adequate to pay college bills, and who would be devastated by having their aid reduced by taxation. I call upon the Committee to avoid this inequity and to change the code to clearly exclude tuition remission from taxation regardless of any service connection it may entail.

The entire question of unrelated business income has been of great concern of late, but I am especially alarmed lest the desire to have a "fair" tax code inadvertently subvert the efforts of private colleges to survive. Charitable gift annuities have been used predominately by less wealthy donors to support less wealthy institutions. This mechanism is now jeopardized by a possible interpretation of Section 501 (m) which taxes certain commercial insurance activities of nonprofits. When a college like ours accepts a charitable gift annuity, it is simply not engaging in a commercial venture. It is trying to raise desperately needed funds in a way which allows donors of modest means to contribute the most. The code must be clarified to maintain the exclusions provided in the Tax Code of 1969, section 514 (c) (5).

GLENSIDE
PENNSYLVANIA
19038-3295

The final item I wish to call to your attention at this time concerns the status of early retirement plans for faculty. Such plans, in which colleges will in effect buy back contracts of unlimited tenure, are often the only ways for colleges on restricted budgets to make room for new, younger scholars. To compromise these plans by maintaining the sub-poverty level restrictions now in place or by the almost incredible notion of treating the buyout amount as a lump sum payment, is both to threaten the careers of many promising young scholars and to toy with the academic vitality of colleges and universities. If these plans come to be treated as deferred compensation, they will literally be useless to individual professors and to their institutions. The tax code should be corrected immediately to clarify that such early retirement schemes are not immediately taxable income, and to allow the terms of such plans to provide a respectable income for retired professors.

Thank you for your consideration, and for seeing that my views are expressed to the Ways and Means Committee.

Sincerely,

Bette E. Landman

Bette E. Landman, Ph.D.
President

CADILLAC PRODUCTS, INC.

COMMENTS ON THE PROVISIONS OF THE TECHNICAL CORRECTIONS BILL OF 1987 (H.R. 2636) - SECTIONS 102(d) AND 109(b) AMENDMENTS RELATING TO SECTIONS 204 AND 902 OF THE TAX REFORM ACT OF 1986

Upon reviewing the Technical Corrections Bill of 1987 (H.R. 2636), it was noted that a major inequity exists which was not recognized in the Tax Reform Act of 1986 (TRA 86) nor in H.R. 2636. Namely, those taxpayers who incurred casualty losses to their business property and who are in the statutory involuntary conversion replacement period during which TRA 86 was enacted, suffer a two-fold detriment in the case of depreciation and the investment credit. In addition, many of these taxpayers may lose certain tax benefits of Industrial Development Bond issues planned to refinance the replacement of business property lost by casualty.

Generally, Section 1033, IRC, provides that, "if property (as a result of its destruction in whole or in part, theft, seizure or a requisition or condemnation or threat of condemnation or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain or loss is recognized." If the property lost by casualty is converted into money, then, if within the statutory period provided, the taxpayer purchases other property similar or related in service or use to the lost property, then deferral of any gain is accomplished if the taxpayer so elects and timely purchases qualified replacement property. The replacement period for such casualties is two years after the close of the first taxable year in which any part of the gain upon the conversion is realized or at such later date as the IRS may designate upon application of the taxpayer.

Thus, under the involuntary conversion provisions of Section 1033, IRC, statutory concessions have been made to place the taxpayer in the same position as he was prior to a casualty without having to pay any tax on any gain realized on the conversion; providing such gain is reinvested in qualified replacement property. However, under the recapture of depreciation provisions of Sections 1245 and 1250, IRC, and the recapture of investment credit provisions under Section 47, IRC, a taxpayer suffering a casualty loss of business property is subject to depreciation and investment credit recapture taxes as a result of the involuntary conversion of property. The taxpayer, before enactment of TRA 86, would be able to take comparable depreciation methods and lives and investment credit on the replacement property as compared with the property lost. However, with the enactment of TRA 86, many taxpayers who are in the replacement period for casualty losses, suffer a double detriment in which they are subject to recapture taxes on property lost and also are faced with less advantageous depreciation write-offs on replacement property and the loss of the investment credit.

Some taxpayers planning an issue of Industrial Development Bonds to help finance the replacement of property lost through a casualty could also be detrimentally affected by certain provisions of TRA 86. TRA 86 continues, for a limited period, the small issue exemption from federal income tax for interest on qualified small issue Industrial Development Bonds. However, TRA 86 denies certain financial institutions a deduction for 100% of their interest expense allocable to buying or carrying tax-exempt obligations acquired after August 7, 1986. It is common practice for financial institutions to acquire, for their own account, entire issues of tax-exempt Industrial Development Bonds. If the interest income they receive on such bonds is, in effect, taxable, inasmuch as an equivalent amount of interest expense has been disallowed, then they will require a higher rate of return on their investment in such bonds.

An example is my employer, Cadillac Products, Inc., its subsidiaries and affiliated company, Cadillac-Ferndale, Inc. These companies lost a manufacturing plant at Terre Haute, Indiana on December 28, 1985. We are in the process of replacing this lost plant and equipment, etc. and expect to have it completed by December 31, 1988 (the expiration date of the statutory replacement period under Section 1033, IRC.) It is presently estimated that we will expend approximately $10,000,000 to replace the building and equipment and approximately $800,000 for the inventory lost in the fire. We also expended over $1,000,000 at our Rogers City, Michigan plant for equipment and modifications to replace plastic film capacity lost at Terre Haute and required to continuously supply our customer, General Motors Corporation. In addition, it is estimated that we will have lost net revenues of approximately $2,000,000 (after business interruption insurance of $1,000,000) which we had planned on utilizing in our business operations. We received $7,839,000 insurance reimbursement to cover the loss of our building, equipment and inventory. As a result of this shortfall in funds required, we have had to arrange a borrowing of $7,000,000 through an Industrial Development Bond issue of which we have received a commitment for the entire issue from Comerica Bank, Detroit, Michigan.

Provisions of TRA 86 (and the Technical Corrections Bill of 1987) which affect taxpayers, and specifically Cadillac Products, Inc., in their efforts to replace business property lost through casualty are:

1. Section 211, TRA 86, providing for repeal of the investment credit for any property placed in service after December 31, 1985. Transitional rules apply to written contracts binding on December 31, 1985 with such property being placed in service during periods from July 1, 1986 to January 1, 1991 depending on the ADR Midpoint Lives.

   Effect on taxpayers -

   Taxpayers, who are not included in TRA 86 transitional exemptions or binding contract exceptions, will not be eligible for the investment credit on any funds expended on casualty loss replacement machinery and equipment purchased after December 31, 1985.

2. Section 201, TRA 86 -

   a. Any non-residential real and residential rental property financed by a tax-exempt bond issue (including Industrial Development Bonds) must use a depreciation recovery period of 40 years, straight line method, for property placed in service after December 31, 1986. Transitional rules apply to property constructed, reconstructured or acquired under a written contract binding as of March 1, 1986 and placed in service by January 1, 1991.

   b. Machinery and equipment with a 5 year recovery period remains at 5 years with 150% declining balance method increasing to 200% for property placed in service after December 31, 1986. There are no transitional rules relative to property with an ADR Midpoint Life less than 7 years.

Effect on taxpayers -

Those taxpayers suffering a casualty loss and without a binding written contract on replacement property as of March 1, 1986 and prior, with financing by tax exempt Industrial Development Bonds, must depreciate non-residential real property and residential rental property over 40 years, straight line method, instead of 19 years straight line method, under the law in effect prior to TRA 86. This same property, without financing through an Industrial Development Bond issue, will have a depreciation recovery period under TRA 86 of 31-1/2 years, straight line method.

3. Section 902, TRA 86, denies banks, thrift plan institutions and other financial institutions a deduction for 100% of their interest expense allocable to buying or carrying tax exempt obligations (including Industrial Development Bonds) acquired after August 7, 1986. Bonds acquired after August 7, 1986 are subject to the 20% interest expense disallowance rule for taxable years ending in 1986. Such bonds are, however, subject to the new 100% interest expense disallowance rule for subsequent taxable years.

Effect on taxpayers -

Those taxpayers suffering casualty losses and who were in the process of replacing their property within the statutory period provided by Section 1033, IRC, and who had not arranged Industrial Development Bond financing through financial institutions by August 7, 1986, find themselves in the position that financing costs (depending on location and market) will be an estimated additional 1-1/2 to 2-1/2%. Cadillac finds that its additional financing costs will be 1-1/2% on $7,000,000 of qualified small issue Industrial Development Bonds not placed with a financial institution by August 7, 1986.

We realize that TRA 86 provided transitional exemptions and exceptions for binding contracts in effect on certain dates as enumerated in the law. However, it can be readily appreciated that companies incurring disastrous business casualty losses and who are replacing property over the long period provided in Section 1033, IRC, could find themselves incurring a double detriment in that they must pay depreciation and investment credit recapture taxes on property lost through casualty and, yet, not receive equal benefits on replacment property due to the enactment of TRA 86. It would appear that relief should be provided for such taxpayers.

Therefore, it is respectfully requested that Cadillac's problem be favorably considered and that the following amendments be added to Sections 102(d) and 109(b) of H.R. 2636:

Section 102(d) . . . . (38) the amendments made by Section 201 shall not apply to . . . .

> "(I) Cadillac Products Inc. and its subsidiaries and affiliated company in relation to the replacement of the building and equipment totally destroyed by fire at Terre Haute, IN on December 28, 1985 with a total replacement project cost of approximately $2,200,000 for the building and $7,800,000 for the machinery and equipment and approximately $1,000,000 of machinery and equipment at Rogers City, MI replacing manufacturing capacity lost at Terre Haute, IN."

Section 109(b)(1) - Paragraph (3) of Section 902(f) of the Reform Act is amended --

. . . .

(D) By adding at the end thereof the following new paragraphs:

. . . .

> "(W)Cadillac Products Inc. and its subsidiaries and affiliated company, plant and equipment replacement relating to the total loss by fire of the manufacturing plant at Terre Haute, IN on December 28, 1985."

We shall be pleased to furnish any other information desired in connection with this matter.

Respectfully submitted,

CADILLAC PRODUCTS, INC.

Albert H. Giuliani,
Treasurer

CALIFORNIA LEAGUE OF
SAVINGS INSTITUTIONS

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Telephone: 213 670-6300

July 15, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
1120 Longworth House Office Building
Washington, D. C. 20515

Re: H.R. 2636 and S. 1350 (Technical Corrections Act of 1987)

Dear Mr. Leonard:

On behalf of the California League of Savings Institutions and its 215 member organizations, we hereby submit our comments with respect to the above-mentioned item.

Modification of 1987 effective tax rate applicable to savings and loan associations.

It is the firm view of the California League that due to legislative oversight in connection with the enactment of the 1986 Tax Reform Act, many savings and loans are currently faced with an anomalous and unreasonable effective tax rate regarding their 1987 tax year.

The legislative history of the 1986 TRA reflects a fundamental, ongoing commitment by both the Administration and Congress to the proposition that as a corollary to the overall increase in the post-1986 corporate taxable base, post-1986 tax rates would not be increased. In this regard the "percentage of taxable income" bad debt reserve method, which is unique to the savings and loan industry, has since its inception in 1951 been treated by Congress, by the regulators and by the accounting profession, as a tax rate concession linked to and conditioned upon an institution's commitment to the primary activity of providing home financing.

The 1986 TRA reduced the general calendar year corporate tax rate from 46% in 1986 to 40% in 1987. The 1986 TRA provided for an additional corporate rate decrease in 1988 and thereafter, but the 1987 "blended" rate is totally consistent with the overriding corporate tax rate precept applied by the 1986 TRA, namely that post-1986 corporate tax rates would thereafter not exceed the 1986 corporate tax rate.

Due to the complexities attendant to the drafting of the 1986 TRA, the reduction provided for the percentage of taxable income bad debt reserve deduction inadvertently violates this principle during 1987. As a consequence, the savings and loan business is in a unique and untenable position, viz: the tax rate applicable to calendar year savings and loans (after taking into account the IRC § 593 percentage of taxable income bad debt deduction) actually increases from 31.28% in 1986 to 36.8% in 1987. After 1987, the tax rate applicable to calendar year associations reverts to 31.28%. Accordingly, while other calendar year corporations are subject to a 13% decrease in their tax rate during 1987, calendar year savings and loans are incurring more than an 17% increase in their tax rate in 1987.

This is clearly neither the intended result nor a fair result. The legislative history establishes a clear pattern of lowering the 1986 tax rate for non-savings and loan corporations by increments in 1987 and thereafter, while retaining the 1986 tax rate for savings and loans. There is no valid policy reason to justify the anomaly of a one-year tax increase applicable to a single industry. Accordingly, there should be a technical amendment to the 1987 percentage of taxable income bad debt reserve method allowance which will assure that the tax rate applicable to savings and loans with regard to their 1987 taxable year shall in no event exceed the pre-1987 and post-1987 rate of 31.28%.

Modification of "at risk" provisions relating to sales of foreclosed real estate ("REO") by savings and loan associations. (Code Section 465).

The Tax Reform Act of 1986 ("1986 TRA") changed the tax consequences of holding real property acquired through the use of non-recourse financing. If a savings and loan provides financing for the sale of its own REO on a non-recourse basis, the purchaser's tax basis in the property is now restricted by the "at risk" rules. If, however, a third party institution regularly engaged in the lending business finances the purchase on a non-recourse basis, the purchaser escapes such tax basis restrictions. It has become apparent, however, that while the new rules have minimal revenue impact, they inhibit normal lending practices and jeopardize the process of an orderly and systematic dispositon of foreclosed properties by thrifts. These new rules are particularly prejudicial to savings and loans operating in 10 states (such as California), where state law prohibits lenders from making recourse loans with respect to sale of their own foreclosed properties.

We believe that historically savings and loans have financed more than 80% of the sales of their own REO. Because of the new law, however, potential purchasers will be unwilling to accept seller financing and will seek to arrange financing from third party lending institutions. In many, if not most of such situations, such alternative financing will simply be unavailable because of a lending institution's inherent unwillingness to finance "a competitor's problem," i.e., previously foreclosed and unfamiliar property held by another financial institution. The ramifications of this hindrance are obvious and unnecessary in light of the fact that numerous other restrictions affecting real estate introduced by the 1986 TRA (e.g., the passive loss rule, depreciation stretchouts, capital gains termination) are more than sufficient to satisfy any reasonable perception of potential tax abuse. The most pressing dilemna faced by troubled savings and loans and the Federal Savings and Loan Insurance Corporation is the disposition of REO. Congress should seek to eliminate, rather than impose, obstacles to the disposition of such troubled properties, particularly since the 1986 TRA negated most of the tax benefits formerly associated with the acquisition of rental real estate and thrust such property into a relatively tax disfavored tax position in terms of investment alternatives.

It is the position of the California League that the "commercially reasonable" exception set forth in Code Section 465(b)(6)(D)(ii) and its rationale are similarly applicable to a situation where a savings and loan is financing sales of its own REO to unrelated third parties; that the failure to include such exception in the 1986 Tax Reform Act should properly be viewed as an oversight; and that the Technical Corrections Act of 1987 should provide appropriate relief for REO sold by savings and loans.

Sincerely yours,

W. Dean Cannon, Jr. (JE)

W. Dean Cannon, Jr.
President

July 17, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

The Chamber of Commerce of the United States respectfully submits the following comments on H.R. 2636, the Technical Corrections Act of 1987. Specifically, these comments address the alternative minimum tax foreign tax credit, the export financing interest exception to the separate basket foreign tax credit limitations, the depreciation rules for computing earnings and profits of a foreign corporation with under 20 percent U.S. source income, passive foreign investment companies and the title passage rule.

1. Export Financing Interest Exception

Code Section 904(d)(2)(G) defines export financing interest as interest received by a taxpayer or a related party engaged in manufacturing, producing, growing, or extracting certain U.S. exports. Under Code Section 904(d)(2), export financing interest is generally excluded from the separate limitations for passive, high withholding tax, shipping, and financial services income. Such interest is treated as overall limitation income.

The Conference Report (page II-565) explains that an export financing interest exception to the separate limitation for passive income is necessary to minimize the risk that tax reform legislation will reduce the availability of export financing and thus have a negative impact on the volume of U.S. exports. The exception is accomplished by exempting export financing income from the new separate basket limitations created by Code Section 904 (d)(2) and treating it as overall limitation income.

Notwithstanding the Conferees' intention, under the definition of export financing interest, banks are ineligible to receive export financing interest because they are prohibited under U.S. banking laws from conducting non-banking activities such as manufacturing, producing, growing, or extracting goods for export and are prohibited from being a related party to such activities. The export financing exception, therefore, excludes banks which can neither be the eligible taxpayer nor a related person under Code Section 904(d)(2)(G).

There is a conflict between Code Section 904(d)(2)(c)(iii), which excepts export financing income from the financial services basket, and the Conference Report, (page II-587), which treats export financing interest as financial services income if it is received by a bank. No statutory provision provides for a banking exception like that referred to in the Conference Report.

The new Subpart F rules of Code Section 954(c)(2)(B) also provide that export financing interest received by banks is not foreign personal holding company income. This preserves in part the prior law bank income exception to the Subpart F rules [old Code Section 954(c)(3)(B)], the remainder of which is repealed by new Code Section 954 (c)(2). The preservation of the deferral, however, is not available to any U.S. bank since banks are ineligible to receive export financing interest.

The Chamber believes that Code Section 904(d)(2)(G) should be amended to effectuate the Conference Report statements and the preservation of the Subpart F deferral rules by removing the requirement that such interest be received by a taxpayer or a related person engaged in manufacturing, producing, growing, or extracting goods for exports. The removal of these requirements would comport with the U.S. banking laws and would thus allow U.S. banks and their foreign subsidiaries to be eligible to receive export financing interest income. In addition, Code Section 904(d)(2)(G)(iii) should be amended to provide that interest received by an entity predominantly engaged in the active conduct of a banking business will be treated as financial services income.

2. Depreciation Rules for Computing Earnings and Profits of a Foreign Corporation with Under 20 Percent U.S. Source Income

Prior to the Act, foreign corporations less than 20 percent of whose gross income was derived from United States sources were permitted to use accelerated methods of depreciation over specified useful lives in computing their earnings and profits. This rule was contained in the last sentence of Section 312(k)(4) which provided that such foreign corporations, in determining earnings and profits, should employ the rules of pre-Act Section 168(f)(2). Section 168(f)(2) provided for either (1) accelerated methods of depreciation or (2) an election to use straight line depreciation. The legislative history of the Act reveals no intent to change this rule. Nevertheless, while the Act deleted the last sentence of section 312(k)(4), Congress inadvertently did not add a provision to Section 312(k)(4) which would expressly allow such foreign corporations to continue using the pre-Act methods of depreciation for purposes of computing their earnings and profits.

The deletion of the last sentence of Section 312(k)(4) was made in Act Section 201(d)(6) as part of the technical and conforming amendments to Act Section 201, which modified the accelerated cost recovery system. Thus, it appears that the deletion of the last sentence of Section 312(k)(4) was not intended to be substantive. In confirmation of that fact, the Conference Agreement, in its description of the alternative cost recovery system, indicates that the new alternative cost recovery system (straight-line depreciation over specified lives) applies for: (1) property used predominantly outside the United States, (2) tax-exempt use property, (3) computing earnings and profits of a domestic corporation or an "80-20 company", and (4) the minimum tax provisions. Conf. Rep. No. 99-841, 99th Cong. 2d Sess. II-44. The Conference Agreement does not indicate that any change was intended in the depreciation rules for computing the earnings and profits of a foreign corporation less than 20 percent of whose gross income is United States source.

Based on the foregoing, the Chamber recommends that a technical correction be made to clarify that the law is in accordance with the intent of the Act so that the depreciation rules applicable in determining the earnings and profits of a foreign corporation that derives less than 20% of its income from United States sources include the accelerated methods as per the Internal Revenue Code of 1954 as amended by Section 201(a) of Public Law Number 97-34. Accordingly, we recommend that the following language be added at the end of Section 312(k)(4):

> In determining the earnings and profits of such a corporation, in the case of recovery property the rules of Section 168(f)(2) shall apply.

3. Passive Foreign Investment Companies (PFIC)

A PFIC is defined in the Act to include any foreign corporation if either 75% or more of its gross income is passive or at least 50% of the average value of its assets produces passive income. For this purpose, a foreign corporation is deemed to own the passive income and passive income producing assets of its lower tier subsidiaries. The definitional test is applied without regard to the number or percentage of U.S. shareholders.

If a foreign corporation is categorized as a PFIC, the U.S. tax consequences are quite severe. Under the Act, the PFIC loses the economic benefit of tax deferral for its earnings by means of an interest charge mechanism that would operate upon distributions of earnings to U.S. shareholders and upon dispositions of PFIC stock. In addition, distributions of income from a PFIC will not generate Section 902 foreign tax credits for taxes paid by the PFIC in a foreign country. As an alternative, these consequences can be avoided if the PFIC makes a special "qualified electing fund" election for its U.S. shareholders, who are to be taxed currently on their proportionate share of the PFIC's income. However, in the event of such election, the income would fall into the separate foreign tax credit basket for passive income and so would be ineligible to absorb excess foreign tax credits generated by other active operations of the U.S. shareholder's group. These provisions generally take effect for tax years beginning in 1987.

The problem with the PFIC provisions is that they are overly broad in scope. As originally drafted, they had the limited purpose of restricting only passive foreign investment funds which were being used by individual U.S. investors to avoid U.S. tax on passive assets. Both the House and Senate versions of the provisions covered only these passive funds, and precluded any overlap that would impose additional tax or penalty on any controlled foreign corporation (CFC) that was already subject to the full panoply of Subpart F rules designed to tax passive foreign income. However, the CFC anti-overlap provisions were omitted from the final version of the Tax Reform Act. The overly harsh result is that the restrictive PFIC provisions now apply not only to passive funds, but also to any CFC with active business operations that generate and accumulate significant cash.

The first draft of the Technical Corrections Act of 1987 contains amendments that somewhat mitigate the PFIC problem. First, the draft removes the restrictions on the availability of Section 902 to generate foreign tax credits on distributions of PFIC income. Second, the draft creates a new look-through rule under the foreign tax credit passive basket provisions, with the effect that PFIC's income would no longer be treated as falling into a separate passive basket. However, the draft contains no amendment correcting the overlapping application of the interest charge rules to U.S. shareholders of a CFC. Therefore, even if the mitigating amendments are enacted, deferral will still be effectively terminated for the active business profits of a CFC that falls under the PFIC rules.

This termination of deferral for any CFC is clearly inappropriate. Congress specifically retained deferral for active income of CFC's though Congress' intent was not put into effect. Therefore, the Chamber recommends adoption of a technical correction which would provide that the PFIC rules are inapplicable to any CFC already subject to the rules of Subpart F.

4. Title Passage Rule

The Act retained the title passage rule for sourcing the income from the sale of inventory property and required that the Treasury Department study the effect of the title passage rule in light of the act's lower tax rates and in light of Congressional trade concerns, and report their findings to Congress by September 30, 1987.

The Chamber believes that other departments besides the Treasury Department may have different expertise bearing on the impact that the title passage rule has on U.S. exports and U.S. competitiveness. Thus, the Chamber recommends adoption of a technical correction amendment requiring that the Commerce Department and the office of the U.S. Trade Representative join Treasury in conducting the study on the title passage rule and to delay the report date of the findings by one year to September 30, 1988. This would result in a more comprehensive and accurate study showing why the current rules provide incentives to U.S. exporters with important trade and competitive ramifications.

1. Alternative Minimum Tax Foreign Tax Credit

The Tax Reform Act of 1986 (the "Act") replaced the old "add on" corporate minimum tax with an Alternative Minimum Tax. The corporate Alternative Minimum Tax is applied to a broader income base (regular taxable income plus adjustments and preferences) and at a lower rate than the regular tax and is payable to the extent it exceeds the regular tax liability. Foreign tax credits as limited by Code Section 904 are allowed as an offset to the minimum tax. However, foreign tax credits cannot offset more than 90 percent of the minimum tax liability.

Allowing a taxpayer to offset no more than 90 percent of the minimum tax liability with foreign tax credits will undermine basic foreign tax credit principles. Disallowing or limiting all other business tax credits in a minimum tax scheme (as is done by the Act) does ensure some threshold of taxation on the related income, but disallowing any portion of a taxpayer's foreign tax credits only ensures international double taxation. The foreign tax credit does not exist to encourage any particular activity (i.e., it is not a preference), and its use does not permit a corporate taxpayer to be effectively untaxed as could be the case with respect to income covered by other business tax credits.

The foreign tax credit exists simply to prevent the taxpayer's foreign source income, which has already been taxed by a foreign jurisdiction, from being taxed again by the U.S. The new provision undermines the basic principle of the foreign tax credit in precluding double taxation and sets a precedent for levying a minimum tax on foreign income regardless of the amount of foreign income tax paid on such income.

The Chamber believes that a technical correction is needed to ensure that foreign tax credits as limited by Code Section 904 be allowed to offset a corporation's minimum tax liability without limitation. To do otherwise would undermine the principle of avoiding double taxation, hurt the expansion of American business abroad and place the U.S. in a difficult position with respect to future negotiations on tax treaties.

Respectfully submitted,

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David G. Koenig
Tax Attorney

COMMENTS
OF
CHURCH ALLIANCE
ON
TECHNICAL CORRECTIONS ACT OF 1987 (H.R. 2636, S. 1350)

The Church Alliance is an organization consisting of the chief executive officers of the pension boards of 28 mainline church denominations having over 65 million members. We ask consideration of the following points for inclusion in the Technical Corrections Act of 1987.

1. Church Self-Funded Death Benefit Programs. Several church death benefit programs are provided either by the church directly or by a church pension board, rather than through the purchase of commercial life insurance. The Deficit Reduction Act of 1984 amended the definition of "life insurance contract" in section 7702(a) to include a requirement that the contract be a life insurance contract under the "applicable law", that is, state or foreign law. This applicable law requirement is extremely troublesome. It means that because church ministers and lay workers reside in all 50 states, the law of each state must be examined to determine whether the church's death benefit program is treated as a life insurance contract under the applicable law. The law of some states is clear that such treatment is available. However, the law in other states on this point is either nonexistent, unclear, or adverse. The result of the "applicable law" requirement will thus be nonuniformity in tax treatment of the proceeds payable under church death benefit programs.

We believe that DEFRA did not intend to prohibit a self-funded death benefit plan from being a life insurance contract for purposes of sections 101(a) and 79, but rather was intended to prescribe rules to restrict the use of so-called life insurance contracts that are essentially investment vehicles. Church self-funded death benefit programs contain no investment or cash value element.

Senator Durenberger has introduced S. 1263, a bill which would clarify the "applicable law" requirement for church self-funded death benefit programs. The Church Alliance urges that S. 1263 or similar legislation to accomplish the same result be incorporated in the Technical Corrections Act. We note that the Technical Corrections Act contains technical amendments to DEFRA. Thus, inclusion of S. 1263 or similar legislation in the current Technical Corrections Act is appropriate.

2. Unfunded Deferred Compensation Plans of Churches and Church-Related Oranizations. The Church Alliance strongly disagrees with the position taken by the Department of the Treasury in Notice 87-13 (January 5, 1987) that section 457 applies to any amount of compensation deferred under a deferred compensation plan, including a deferred compensation agreement or arrangement, whether or not such agreement or arrangment is individually negotiated. The Church Alliance believes that the Revenue Act of 1978 (which introduced section 457 into the Code), the Tax Reform Act of 1986 (which did not change the scope of section 457), and the underlying legislative history of both Acts require only those amounts of compensation which are deferred under the individual option of an employee to be subject to section 457. The Technical Corrections Act should make this point clear by reversing the position taken in Notice 87-13 on this issue.

Moreover, the Church Alliance objects to the application of section 457 to churches and church-related organizations. This in effect, eliminates a vital method of enhancing the retirement benefits of ministers and lay employees. The Church Alliance sees no justification in treating tax-exempt employers and their employees more severely than taxable employers and their employees with respect to unfunded deferred compensation.

We are aware that the section 457 Task Force has filed comments on this issue. We have reviewed its comments and fully support them.

3. Specific Removal of Charitable Gift Annuities from the Operation of Section 501(m). The Church Alliance strongly supports "providing annuities that meet the tests described in section 514(c)(5)" as a specific exception from the definition of commercial-type insurance under section 501(m)(3). For over 100 years, the charitable gift annuity has been an important means to charitable organizations for raising modest gifts. The transaction arises when a donor wants to benefit a favorite charity but cannot afford to live without the income from the gift. He makes a gift of cash or property but reserves an annuity, which is valued at significantly less than the amount of the transfer. The donor is thinking in terms of benefiting a charity rather than of buying an annuity.

A charitable remainder annuity trust produces substantially the same results as a charitable gift annuity but is outside the purview of section 501(m). However, because of the expenses of creating and administering it, a viable charitable remainder annuity trust cannot be created unless the gift is substantial. The charitable gift annuity is nothing more than a poor man's charitable remainder annuity trust.

Since 1969 section 514(c)(5) had defined the type of charitable gift annuity that should be subject to the unrelated business income tax. Therefore, the Church Alliance believes that Congress in 1986 did not envision subjecting charitable gift annuities to section 501(m).

There can be no revenue loss from a provision excepting charitable gift annuities from the term "commercial-type insurance" since it would not appear that any revenue was projected from this source in the beginning.

4. Participation Rules for Church Section 403(b) Annuity Programs. The Church Alliance notes that there is a question under section 403(b)(12)(A) (as redesignated by the Technical Corrections Act) whether the participation rules of section 410(b) or the pre-ERISA participation rules (see section 410(c)(2)) apply to those contracts which are not purchased by a "church" as defined in section 403(b)(12)(B) but which are provided under a church plan. The Church Alliance believes that the pre-ERISA participation rules should apply to those contracts, and this should be clarified in the Technical Corrections Act.

CHURCH ALLIANCE

By Gary S. Nash

Gary S. Nash, Secretary

Comments of Citicorp
on the Technical Corrections Act of 1987, H.R. 2636
Submitted to the Committee on Ways and Means
U.S. House of Representatives
July 17, 1987

Citicorp wishes to thank the Committee for giving it the opportunity to comment upon H.R. 2636, the Technical Corrections Act of 1987, and to suggest additions thereto. These comments and suggestions are summarized below.

- Citicorp recommends that the reporting requirements imposed on a real estate mortgage investment conduit be made as simple as possible as well as prospective in application.
- Citicorp recommends that the look-through rules for interest and dividends from controlled-foreign corporations should be extended to the foreign source portion of interest and dividends from 80/20 companies.
- Citicorp recommends that any U.S. member of a group controlled by a bank holding company be deemed to have satisfied the predominantly engaged test for purposes of the financial services income separate limitation.
- Citicorp recommends that the Act be amended to fix a percentage of income attributable to financial services income above which an entity is deemed to be "predominantly engaged."
- Citicorp recommends that the statute be amended to clarify that expenses are to be allocated at the U.S. recipient level under current Treasury Regulations Section 1.861-8 rules.
- Citicorp recommends that the bill be modified to allow banks to receive export financing interest and treat it as financial services income, without regard to whether such interest is subject to a high withholding tax.
- Citicorp recommends that accumulated deficits in earnings and profits attributable to taxable years of a controlled-foreign corporation beginning before 1987 be eligible to reduce Subpart F income in taxable years after 1987.
- Citicorp recommends that, in determining the functional currency of a qualified business unit, the taxpayer should be allowed to use the same functional currency for the qualified business unit as is used for such taxpayer's U.S. financial accounting reporting purposes.
- Citicorp recommends that the term "foreign income taxes" be amended to include "in lieu of taxes."
- Citicorp recommends that a taxable mortgage pool be treated as a separate corporation for all purposes under the Internal Revenue Code.

Financial Institution Provisions

Statutory Provision

Code Section 265(b); Act Section 902(a)

Act Section 902(a) adds Code Section 265(b) which disallows the interest expense of a financial institution in a ratio equal to the ratio of the adjusted basis of the taxpayer's tax-exempt obligations to the adjusted basis of all the taxpayer's assets. A tax-exempt obligation includes the shares of a regulated investment company ("RIC") if the RIC "during the taxable year of the holder thereof distributes exempt interest dividends". Thus, the full adjusted basis of the shares is included in the numerator even if the RIC distributes both taxable and tax-exempt interest dividends or if the RIC distributes the exempt-interest dividend during the holder's taxable year but prior to the holder's acquisition of the RIC shares.

Issue Presented

In the event of the above inclusion, the taxpayer's interest disallowance exceeds the amount which is allocable to tax-exempt interest. The Conference Report is unclear as to how this provision applies.

Recommendation

This provision should be modified by requiring the inclusion of RIC shares in the numerator only in the proportion that the exempt-interest dividends received by the holder during its taxable year bears the total dividends received by the holder from the RIC during the holder's taxable year.

REMIC Reporting

Statutory Provisions

Code Sections 860A-860G; Act Sections 671-675

A new entity, called a REMIC, has been created which will hold a fixed pool of real estate mortgages and issue multiple classes of interests to investors designated as regular or residual interests. In general, the REMIC, like the partnership, will not be treated as a separate taxable entity, but instead its income will be passed through to investors. The REMIC will also have information reporting responsibilities to the holders of interests with regard to interest and OID.

Issue Presented

The Conference Report indicates (page II-237) that the REMIC will also have reporting responsibilities for accruals of market discount and amortization of premium in accordance with provisions of the conference agreement. Code Section 6049(d)(7) gives the IRS broad authority to create exemptions from reporting for various entities, and in general tells the IRS to promulgate regulations to carry out the reporting responsibilities. In addition, the Conference Report (page II-237 fn. 19), although stating that market discount and amortization reporting is to be carried out in accordance with provisions of Act Section 1803(a)(13), does not define exactly what provisions apply in the case of the REMIC. Code Section 860G also states in very general terms that the IRS shall promulgate regulations necessary to allow proper computation of taxable income of investors under the REMIC provision.

Recommendation

In view of the extreme complexity of the new REMIC provisions, reporting requirements imposed on a REMIC should be minimized and made as simple as possible to provide useful and intelligible information to investors and sufficient information to the IRS. Because interests in REMICs will be issued to investors prior to the promulgation of any regulations, all reporting obligations of the REMIC should be prospective to avoid unnecessary disruption in the markets for these interests. The statute should specify the reporting responsibilities and procedures of the REMIC under all applicable Code sections.

Foreign Source Rules

Statutory Provision

Code Sections 861(a)(1)(A) and (i); Act Sections 1214(a) and (c)

Dividend and interest income generally is sourced in the country of residence of the payor. Accordingly, interest and dividends paid by U.S. companies are generally U.S. source income to the recipient while interest and dividends received from foreign corporations are generally foreign source income. However, if a U.S. corporation derives more than 80 percent of its income from foreign sources (e.g., constitutes an "80-20 company"), a certain portion of the dividends and interest paid by that corporation are treated as foreign source income.

Issue Presented

For purposes of calculating the foreign tax credit limitation, Code Section 904(d) provides that the foreign source interest and dividends received by "U.S. shareholders" (generally, a U.S. person with a 10 percent or greater stock interest) from controlled foreign corporations (CFC's) are subject to look-through rules based on the nature of the payor's income. Thus, interest received by a U.S. shareholder from a CFC whose income is derived from a foreign manufacturing operation is overall basket income rather than passive income. Comparable look-through rules are not provided for interest and dividends paid by 80-20 companies. Accordingly, interest received by a U.S. shareholder from a majority U.S.-owned 80-20 company with a foreign manufacturing business would be passive income. In order to provide consistency with the treatment of other foreign source interest and dividends, it may be appropriate to provide look-through rules applicable to the foreign source portion of interest and dividends received from 80-20 companies similar to the rules applicable to interest and dividends received from CFC's.

Recommendation

The look-through rules for interest and dividends from CFC's should be extended to the foreign source portion of interest and dividends from 80-20 companies. Since the interest expense of an 80-20 company and the related income of a U.S. corporate payee would offset each other if both companies are included in the same consolidated return, the need for look-through rules with respect to interest only appears to apply where the 80-20 company is not included in the same consolidated return as the interest recipient.

Statutory Provision

Code Section 904(d)(2)(C)(ii); Act Section 1201(b)

If an entity is predominantly engaged in the active conduct of a banking business, the separate limitation for financial services income will apply to any passive income earned by the entity in that year as well as to financial services income.

Issue Presented

Under the Conference Report (page II-571), the predominantly engaged test is deemed to have been satisfied if, in cases involving the separate limitation look-through rules, either the U.S. income recipient or the related payor of the income independently satisfies the test. It is unclear whether this test will also be met where both the U.S. income recipient and the payor are not predominantly engaged in the active conduct of a banking business, but the U.S. income recipient is a member of a group controlled by a bank holding company.

Recommendation

The statute shuld be amended to specify that a U.S. member of a group controlled by a bank holding company is deemed to have satisfied the predominantly engaged test for purposes of the separate limitation for financial services income. This rule should apply regardless of whether the U.S. member (income recipient) or the payor have independently satisfied the predominantly engaged test. Justification for this result is based upon the fact that a bank holding company and the members it controls are highly regulated banking groups whose predominant activity must be banking or finance. As part of an integrated and regulated controlled group, a U.S. member should be deemed to be predominantly engaged in the same business as that of the bank holding company which controls it.

Foreign Tax Credit Limitations

Statutory Provision

Code Section 904(d)(2)(C)(ii); Act Section 1201(b)

The term "financial services income" includes what would otherwise be passive income if the entity which derives such income is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. Act Section 1201(b)(2)(C)(ii) and Code Section 904(d)(2)(C)(ii). This special tax rule is the counterpart to the banking exception in the Subpart F provisions under prior law. Its purpose is to permit an entity to treat certain passive types of income such as dividends and interest as active income if it is earned while the entity is predominantly engaged in a banking or financing activity.

Issues Presented

The Conference Report does not specify how high a percentage the entity's income must be attributable to financial service activities or what specific activities, if any, the entity must perform in order for it to be considered predominantly engaged in the active conduct of a banking, insurance, financing or similar business. Instead, it is left to the discretion of the Secretary to promulgate regulations for such a determination.

The Conference Report (page II-571) states that an entity which satisfies the predominantly engaged test may earn income that is integrally related to its banking, insuring, or financing activity. Such income is to be treated as financial services income even though it would not otherwise be classified as such. An example cited is income from equipment leasing. It is not clear from the preceding whether a foreign leasing facility (subsidiary) will meet the predominantly engaged test if its leasing income constitutes its primary source of income.

Recommendations

The statute should be amended to fix a percentage of income attributable to financial service activities above which an entity is considered to be "predominantly engaged".

Equipment leasing should qualify as a financial activity; consequently, the income earned therefrom should be considered financial services income even if, under financial lease terms, such income is to be treated as equivalent to interest.

Statutory Provision

Code Section 904(d)(2)(F); Act Section 1201(b)

Under the new high-tax kick-out rule, passive income is excluded from the separate limitation for passive income and put into the overall limitation when the foreign tax paid with respect to that income exceeds the highest U.S. tax rate multiplied by the amount of that income after allocation of parent expense. Act Section 1201(b)(2)(F) and Code Section 904(d)(2)(F).

Issue Presented

The Conference Report does not specify whether U.S. or foreign tax concepts should apply in determining whether a particular item of income is high-taxed. What method of allocating the expenses of the parent against the passive income of the subsidiary should be used? Where the foreign income is subject to tax under a single tax base or different bases than the U.S. tax base, rules are needed to allocate those taxes between items of income. For example, how are foreign taxes paid by a foreign corporation allocated between passive and active income when the foreign country has different timing, characterization, and deduction rules? The Conference Report does not explain how the amount of foreign income tax paid with respect to a particular item of tax is to be determined. Finally, the issue of when an item of income is to be treated as high-taxed is not addressed. For example, is the income treated as high-taxed where it is not high-taxed when accrued but is high taxed when distributed in a subsequent year (e.g., a foreign subsidiary is on a cash basis for local tax purposes, while the U.S. parent is on the accrual basis)?

Recommendations

The statute should be amended to clarify that expenses are to be allocated at the U.S. recipient level under current Treasury Regulations Section 1.861-8 rules. It should also address the issue of determining when an item of FPHC income is deemed to be high-taxed. The appropriate date of determination should correspond to the date of U.S. income inclusion or deemed inclusion (e.g., a subpart F inclusion). To the extent that the foreign tax rate differs when the income is subsequently distributed (as income previously taxed under Subpart F), an adjustment in the tax liability should be made. This approach is consistent with present law's special rules for determining foreign tax credits with respect to earnings and profits previously taxed under Subpart F. See Code Section 960(b).

Export Financing Interest Exception

Statutory Provision

Code Section 904(d)(2)(G); Act Section 1201(b)

H.R. 2636, Section 112

New Code Section 904(d)(2)(G) defines export financing interest as that received by a taxpayer or a related party engaged in manufacturing, producing, growing, or extracting certain U.S. exports. Under Code Section 904(d)(2) generally, export financing interest is excluded from the separate limitations for passive, high withholding tax, and shipping income. The bill provides that export financing interest is financial services income if it is received by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, if such income is subject to a high withholding tax. Otherwise, such interest is treated as overall limitation income.

Issues

The Conference Report (page II-565) includes an export financing interest "exception" to minimize the risk that tax reform legislation will reduce the availability of export financing and thus negatively impact the volume of U.S. exports. This is accomplished by exempting export financing income from the new separate limitations created by Code Section 904(d)(2) and treating it as overall limitation income with one exception. In addition, if received by a bank, export financing interest is not subject to the repeal of banking income deferral under Subpart F. Code Section 954(c)(3)(B).

Notwithstanding the Conferees' intention under the definition of "export financing interest", banks are ineligible to receive export financing interest because they are prohibited under U.S. banking laws from conducting non-banking activities such as manufacturing, producing, growing, or extracting goods for export and are prohibited from being a related party to such activities. The export financing exception, therefore, excludes banks which can neither be the eligible taxpayer nor a related person under Code Section 904(d)(2)(G).

The new Subpart F rules of Code Section 954(c)(2)(B) also provide that export financing interest received by banks is not foreign personal holding company income. This preserves in part the previous law bank income exception to the Subpart F rules [old Code Section 954(c)(3)(B)], the remainder of which is repealed. Code Section 954(c)(2). The preservation of the deferral, however, when coupled with the limitation on entities eligible to receive export financing interest under Code Section 904(d)(2)(G), is not available to any U.S. bank barred from receiving export financing interest (because it is either not engaged in manufacturing, etc., or it is not a party related to any manufacturer, etc.).

The bill also requires that export financing interest be subject to a high withholding tax in order to be treated as financial services income by a banking, insurance, finance, or similar company. If such interest is subject to a gross basis tax of less than five percent, even if received by an entity predominantly engaged in banking, etc., it is overall limitation income. The bill explanation states that this will allow manufacturers and the other listed eligible recipients of export financing interest to cross-credit low taxed export financing interest against other higher taxed overall limitation income. Thus, even if banks were eligible to receive such interest, placing it in the overall limitation (where banks have no other income) results in a loss of the benefits of such income and the foreign taxes paid thereon.

Recommendations

Code Section 904(d)(2)(G) should be amended to effectuate the Conference Report statements and the preservation of the Subpart F deferral rules to remove the requirement that such interest be received by a taxpayer or a related person engaged in manufacturing, etc. The removal of the "engaged in . . . manufacturing", etc., and the "related party" requirements would comport with the U.S. banking laws and would thus allow U.S. banks and their foreign subsidiaries to be eligible to receive export financing interest income.

The bill should be amended to exclude the requirement that export financing interest be subject to a high withholding tax in order to be treated as financial services income where that interest is received by an entity predominantly engaged in the active conduct of a banking business.

Statutory Provision

Code Section 952(c)(1)(B); Act Section 1221(f)

For taxable years beginning after December 31, 1986 accumulated deficits in earnings and profits can reduce current earnings and profits of a CFC only if the deficit is attributable to certain qualified activities and only to the extent of current earnings and profits from the corresponding qualified activity. Only accumulated deficits for taxable years beginning after December 31, 1986 may be carried forward to reduce subpart F income.

Issue Presented

The Conference Agreement states several reasons for the limitation on the use of accumulated deficits to reduce subpart F income, including making the subpart F rules consistent with the changes in the foreign tax credit separate limitation rules and preventing taxpayers from sheltering passive investment income from U.S. taxation by moving those investments into CFC's with prior years deficits. No explanation is given however, for eliminating the use of accumulated deficits incurred in taxable years prior to January 1, 1987.

Recommendation

The rule that accumulated deficits in earnings and profits attributable to taxable years of the CFC beginning before 1987 may not be carried forward and used to reduce subpart F income in taxable years after 1987 is unduly harsh. Pre-1987 deficits in earnings and profits which the taxpayer can establish to the satisfaction of the Secretary are attributable to activities that under current law would have been treated as qualified activities should be permitted to be carried forward in the same manner as post-1986 deficits attributable to qualified activities.

Statutory Provision

Code Section 985; Act Section 1261

All determinations under the Internal Revenue Code of 1986 must be made in the taxpayer's functional currency. In the case of a qualified business unit, the functional currency is determined, in essence, pursuant to a facts and circumstances test.

Issues Presented

What rules should be applied to determine what constitutes the functional currency of a qualified business unit?

Under certain circumstances to be set forth in regulations, a taxpayer may elect the U.S. dollar as the functional currency of a qualified business unit. The Conference Report (page II-661) indicates that such election may be conditioned on the taxpayer electing the U.S. dollar as the functional currency of all of its qualified business units. Is this rule warranted?

The Conference Report (page II-659), referring to the Senate Amendment, indicates that pending issuance of regulations, original issue discount on nonfunctional currency denominated obligations will be determined in terms of units of the nonfunctional currency and translated into the functional currency using the average exchange rate for the accrual period. Is this approach reasonable?

Recommendations

Since rules similar to those prescribed in FASB 52 were intended to apply in determining the functional currency of a qualified business unit, a taxpayer should, as a safe-harbor, be allowed to use the same functional currency of a qualified business unit for income tax purposes as is used for such taxpayer's U.S. financial accounting reporting purposes. Clarification of this issue is extremely important not only for purposes of determining the taxable income and earnings and profits of a qualified business unit, but also for purposes of determining the tax consequences attributable to various transactions entered into by a qualified business unit (e.g., interest rate conversion agreements).

Inclusion of In Lieu Of Taxes

Statutory Provision

Code Section 986; Act Section 1261

Code Section 986 provides rules to determine the U.S. dollar amount of foreign income taxes paid by a foreign corporation for purposes of Code Sections 902 and 960. The term "foreign income taxes" as defined in Code Section 986(b)(2) does not currently include Code Section 903 "in lieu of" taxes.

Issue Presented

Should "in lieu of taxes" be included in the definition of foreign income taxes under Code Section 986(b)(2)?

Recommendation

Code Section 903 or Code Section 986(b)(2) should be amended to provide that for purposes of subpart J the term "income, war profits or excess profits taxes" shall include a tax paid in lieu of such taxes otherwise generally imposed by any foreign country or by any possession of the United States.

Treatment of Taxable Mortgage Pools

Statutory Provision

Code Section 7701(i); Act Section 673

Code Section 7701(i)(2) defines a taxable mortgage pool (TMP) as any entity, other than a REMIC, if (1) substantially all the assets consist of debt obligations, and more than 50% of the obligations consist of real estate mortgages; (2) the entity is the obligor on debt obligations with 2 or more maturities; and (3) under the terms of the debt obligations on which the entity is obligor, payment made by the TMP bears a relationship to payments by underlying obligors on debt obligations held by the TMP. Code Section 7701(i)(2)(b) states that any portion of an entity meeting this definition is treated as a TMP. Code Section 7701(i)(1) states that a TMP shall be treated as a separate corporation which may not be treated as an includible corporation with any other corporation for purposes of Code Section 1501.

Issue Presented

The Conference Report (page II-239) confirms that a REMIC is to be the exclusive means of issuing multiple classes of real estate mortgage-backed securities without two-levels of taxation, and that a TMP is to be treated as a separate corporation not includible in a consolidated return. It is not clear, however, whether a TMP is to be treated as a separate corporation for all purposes under the Internal Revenue Code.

Recommendation

Code Section 7701(i)(1) should be amended to state that a TMP is to be treated as a separate corporation for all purposes under the Internal Revenue Code. Treating a TMP as a separate corporation for all purposes of the Code has the benefit of providing a single, consistent set of rules for the treatment of TMPs.

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SHAKER HEIGHTS, OHIO 44122
(216) 831-1352

July 24, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard,

Enclosed is a copy of comments submitted to Senate Finance re: the Technical Corrections Bill. Although, I realize we are now past your deadline, the comments are purely technical in nature, and I hope therefore, you will consider them.

If you have any questions, please have a member of your staff contact me at the above address and phone.

Very truly yours,

Kenneth S Cohen
Kenneth S. Cohen
Author of the BNA Income Tax
Spreadsheet Computer Program

KENNETH S. COHEN
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July 21, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

Dear Ms. Wilcox,

I am writing to comment on the Technical Corrections Bill, S1350,HR2630. The following are the matters I believe are still in need of attention.

1. Social Security Inclusion and IRA limitations. There is a circular computation here. Sec. 219 says that AGI for IRA limitation purposes is computed after the Social Security Inclusion in Sec. 86 but Sec. 86, as it now stands, does not say that AGI for its purposes is to be computed without regard to Sec. 219.

2. Lump Sum Computations. The new rules for lump sum distributions for taxpayers who were over 50 on 1/1/86 are not clear insofar as to how the computation of the 20% tax (TRA Sec. 1122(h)(3)(B)) is to integrate into the rest of the individual tax computation. Is the capital gain to be included with the individual's general long-term capital gain so that offsetting capital losses may be applied against it? If so, what is the order of application of the losses? Does the lump sum capital gain form part of the net capital gain that in 1987 may be subject to the general alternative capital gains tax? If it does not form part of the net long term capital gain, does it go into AGI at all, or is the 20% tax simply computed after all other taxes? These issues are important for alternative minimum computations among other things. With regard to this, note that Sec. 55 excludes from its regular tax computation (with which the tentative alternative minimum tax is to be compared) the tax under Sec. 402(e). Act Sec. 1122(h)(3)(C) says that the election to apply the existing capital gain provisions is to be treated as a 402(e)(4)(B) election. This implies that the 20% tax is part of the 402(e) computation, which in turn implies that the capital gain is not part of AGI for regular or alternative minimum purposes. This should be clarified.

3. Minor Child Taxes.

   A. Credits. The application of credits for Minor children under 14 who are subject to the new alternative minimum tax computation is not clear. Is the alternative minimum foreign tax credit limit to be redone with each of the hypothetical computations required by the new provision? (I would strongly suggest the answer be no.) What about other non-refundable credits? As presently drafted these appear to be allowed when the child's own tentative minimum tax is less than his regular tax even though he actually has a net minimum tax by virtue of the new computation. (The solution here might be to say that for purposes of the credits, where the new alternative minimum computation applies, the child's tentative minimum tax shall be deemed to be the sum of his regular tax and his newly computed net alternative minimum tax.)

   B. The Minimum Tax Credit. The computation of the child's minimum tax credit is not clear. Specifically, are the parent's timing preferences to be taken into consideration in computing the child's credit or just the child's timing preferences? In other words in doing the computation twice, once with timing differences and once without, are the parent's timing differences to be put in and taken out or just the child's?

4. Alternative Minimum Tax. The Corrections bill does not address some of the difficult questions under the new alternative minimum tax for individuals. These are:

   A. Which if any of the following limits gets recomputed for alternative minimum purposes based on a recomputed alternative minimum AGI?

Medical Expenses
Casualty Losses
Social Security Inclusion
Passive Loss Real Estate Exclusion
IRA limits
Charitable contribution limits

B. Is above the line Schedule E investment interest subject to the limitations of Section 55(b) which refers only to Itemized Deductions? (I would suggest that the computation of investment interest start over with total investment interest for alternative minimum purposes and not be tied to itemized deductions.)

C. Is the carryover of investment interest for regular tax purposes from 1986 to 1987 allowed for alternative minimum purposes? Under prior law, except for limited business interest, such carryovers were allowed by virtue of their inclusion in AGI or itemized deductions which formed the starting point of the alternative minimum interest computations.

5. Investment Interest. It is not clear whether the carryover of investment interest for regular tax purposes from 1986 to 1987 is subject to the phase out rule or not. For example, a taxpayer has $20,000 of investment interest in 1986. He deducts $10,000 and carries over $10,000. In 1987 he has none. Does he deduct $6,500 or 0?

6. Passive Activities. The order of application of gains and losses from different types of activities needs to be clarified. As the statute now stands there are two major categories entitled to special treatment, pre-enactment interests and real estate. These categories have overlapping elements making the computation as described in the statute virtually impossible without creating double deductions. I have taken the liberty of designing a form to resolve this problem which I have submitted to IRS. See attached. At this writing, I have received no response, but the ordering of gains and losses contained in the form or a similar ordering is necessary and may not be valid without specific statutory authority.

If I can be of any further assistance, please feel free to have a staff person contact me at the above address and phone.

Kenneth S. Cohen

Author of the BNA Income Tax
Spreadsheet Computer Program

Passive Activity Gain and Loss		Comments
Part I.		
1 Net income or (loss) from pre 86 TRA active real estate interests.	(20,000.00)	
2 Net income or (loss) from post 86 TRA active real estate interests.	(10,000.00)	
	....	
3 Active real estate income or (loss). Add lines 1 and 2.	(30,000.00)	Offsets gain or loss from line 1 against gain or loss from line 2.
	....	
4 Net income or (loss) from pre 86 TRA non active real estate interests.	(100,000.00)	
5 Net income or (loss) from post 86 TRA non active real estate interests.	30,000.00	
	....	
6 Non active real estate income or (loss). Add lines 4 and 5.	(70,000.00)	Offsets gain or loss from line 4 against gain or loss from line 5.
	....	
7 Add lines 3 and 6. If the result is a net gain do not complete the rest. Instead post the gain to line xxx of form 1040.	(100,000.00)	
	....	
Part II.		
8 If lines 1 and 3 are both losses enter the smaller. Otherwise enter 0.	(20,000.00)	
9 If lines 4 and 6 are both gains enter the smaller. Otherwise enter 0.	0.00	
	....	
10 Add lines 8 and 9.	(20,000.00)	Offsets remaining loss from line 1 by remaining gain from line 4.
	....	
11 If lines 2 and 3 are both losses enter the smaller. Otherwise enter 0.	(10,000.00)	
12 If lines 5 and 6 are both gains enter the smaller. Otherwise enter 0.	0.00	
	....	
13 Add lines 11 and 12.	(10,000.00)	Offsets remaining loss from line 2 by remaining gain from line 5.
	....	

14 If lines 4 and 6 are both losses enter the smaller. Otherwise enter 0.	(70,000.00)	
15 If lines 1 and 3 are both gains enter the smaller. Otherwise enter 0.	0.00	
	-----------	
16 Add lines 14 and 15.	(70,000.00)	Offsets remaining loss from line 4 by remaining gain from line 1.
	-----------	
17 If lines 5 and 6 are both losses enter the smaller. Otherwise enter 0.	0.00	
18 If lines 2 and 3 are both gains enter the smaller. Otherwise enter 0.	0.00	
	-----------	
19 Add lines 17 and 18.	0.00	Offsets remaining loss from line 5 by remaining gain from line 2.
	-----------	
20 Loss if any from line 10 (Enter as a positive number).	20,000.00	Converts remaining loss from line 1 to a positive number.
21 Gain if any from line 13.	0.00	
	-----------	
22 Net pre 86 TRA active real estate loss (Subtract line 21 from 20).	20,000.00	Offsets remaining loss from line 1 by remaining gain from line 5.
	-----------	
23 Loss if any from line 13 (Enter as a positive number).	10,000.00	Converts remaining loss from line 2 to a positive number.
24 Gain if any from line 10.	0.00	
	-----------	
25 Net post 86 TRA active real estate loss (Subtract line 24 from 23).	10,000.00	Offsets remaining loss from line 2 by remaining gain from line 4.
	-----------	
26 Loss if any from line 16 (Enter as a positive number).	70,000.00	Converts remaining loss from line 4 to a positive number.
27 Gain if any from line 19.	0.00	
	-----------	

28 Net pre 86 TRA non active real estate loss (Subtract line 27 from 26).	70,000.00	Offsets remaining loss from line 4 by remaining gain from line 2.
29 Loss if any from line 19 (Enter as a positive number).	0.00	Converts remaining loss from line 5 to a positive number.
30 Gain if any from line 16.	0.00	
31 Net post 86 TRA non active real estate loss (Subtract line 30 from 29).	0.00	Offsets remaining loss from line 5 by remaining gain from line 1.
32 Total passive loss. Add lines 22, 25, 28, and 31.	100,000.00	This should be the same as the negative amount on line 7.
33 Total active real estate loss. Add lines 22 and 25.	30,000.00	
34 Individuals enter $25,000 ($12,500 if married filing separately).	25,000.00	
35 Adjusted gross income (see instructions).	0.00	
36 Individuals enter $100,000.	100,000.00	
37 Subtract line 36 from line 35. If less than 0 enter 0.	0.00	
38 Divide line 37 by 2.	0.00	
39 Maximum exemption. Subtract line 38 from line 34. If less than 0 enter 0.	25,000.00	
40 Exemption allowed. Enter the smaller of line 33 or line 39.	25,000.00	
41 Line 40 times line 22 divided by line 33.	16,666.67	The part of the the real estate exemp. allocable to pre 86TRA interests.
42 Subtract line 41 from line 22.	3,333.33	Pre 86 TRA real estate after exemption.
43 Add lines 42 and 28.	73,333.33	Total pre 86 interests after offset of gain and allocation of exemp.
44 Phase in allowed. Multiply line 43 by 65%	47,666.67	
45 Total allowable passive activity loss. Add lines 40 and 44. Post to form 1040 line xxx as a negative amount.	72,666.67 ============	Total of real estate exemption and phase in allowance.

Columbia University in the City of New York | *New York, N.Y. 10027*

VICE PRESIDENT FOR GOVERNMENT RELATIONS
AND COMMUNITY AFFAIRS

301 Low Library

July 6, 1987

Mr. Joseph K. Dowley
Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Dowley:

I write on behalf of Columbia University to urge your careful consideration of three issues now being considered under the Technical Corrections bill by the House Committee on Ways and Means. These issues are the treatment of tuition remission provided to graduate teaching and research assistants, charitable gift annuities and early retirement plans for faculty. Each of these issues are briefly described below.

The Tax Reform Act of 1986 appears to have drawn new distinctions in the taxation of student scholarships and fellowships. Under the previous law, exclusion from gross income was permitted both for tuition remission and scholarships linked to teaching and research. The rationale is the academic practice of integrating teaching and research activities into degree programs. One section of the new law, section 117 (c), eliminates the tax-exempt status of tuition remission which compensates teaching and research. Another part of the same section of the law (section 117 (d) as amended by section 127 (c)(8)) was continued without amendment in the new law, and it retains the tax-exempt status of service-linked tuition remission programs. Thus, the same section of the Code contains a general rule taxing service-linked awards and a specific rule exempting tuition remission awards. In our view, the change in tax policy as reflected in the general rule is unfortunate and based upon an inaccurate perception of the role of teaching and research in higher education. Although funding is granted to compensate student services, the intent of these services is not to provide university-funded employment. Rather, teaching and research constitute a fundamental and integral element in graduate programs in higher education. They afford hands-on experiences that are critical to young scholars who will pursue careers in teaching and research. Because students engaged in these activities are the primary beneficiaries, there should be no negative tax consequence for service-linked tuition remission programs. We urge that the Technical Corrections bill clarify the point that tuition remission provided to graduate teaching and research assistants is completely exempt from taxation.

Charitable gift annuities, through which a donor may give an immediate gift to a nonprofit organization and receive back a specified income for life, have never been treated as an unrelated trade or business. In fact, in 1969, Congress added section 514 (c)(5) to the Tax Code specifically directing the treatment of charitable gift annuities under the unrelated business income tax. This section was not amended by the Tax Reform Act; however, a new section 501 (m), which taxes commercial insurance activities of nonprofits, could be read to include charitable gift annuities. A clarification is needed so that this method of making charitable gifts--which is predominately utilized by less wealthy donors--does not subject the nonprofit recipients of these gifts to the unrelated business income tax. Failure to make this clarification will discourage the use of this important method of giving to charitable institutions.

Finally, the Tax Reform Act imposes limitations on the deferred compensation arrangements available to employees of nonprofit organizations which parallel limitations previously placed upon employees of public institutions (section 457). These changes impose upon new deferred compensation plans two significant restrictions: first, that eligible deferred compensation plans are limited to $7,500 per annum or 33 and 1/3 percent of compensation; and second, that such plans are considered elective contributions for tax-sheltered annuity catch-up rules. Plans which exceed this amount are treated as immediately taxable to the beneficiary. The Act does not specify that these early retirement plans are to be considered as deferred compensation. However, in January, 1987, the Internal Revenue Service issued an interpretation (Notice 87-13, January 26, 1987) which treats these plans as deferred compensation. This broad definition has wide-ranging implications for the ability of campuses to seek voluntary termination of tenure agreements. We urge the Committee to clarify that early retirement plans for faculty, which in essence buy back an unlimited tenure contract, are not taxable as deferred compensation.

We appreciate your consideration of our concerns, and would be pleased to provide additional information.

With best wishes,

Sincerely,

Gregory Fusco

Gregory Fusco
Vice President

Committee of Banking Institutions on Taxation

ESTABLISHED 1918

This Committee consists of National and State Banks, Trust Companies, Private Banking Institutions and Agencies of Foreign Bankers. The members of its executive committee and its officers are selected from representatives of these institutions. Its objects are (a) to cooperate in assisting in the administration of tax laws; (b) to disseminate among its members information pertaining thereto; and (c) to act as a clearing house for communications to or instructions from Federal and State tax Authorities.

Vincent P. Amato, Chairman
Michael T. Scarpinato, Vice Chairman
Arthur Gilman, Secretary
William T. Hayden, Treasurer

Address all communications to

Albert G. Doumar
Vice President
Chase Manhattan Bank
1211 Avenue of the Americas
New York, NY 10036
Tel. No. (212) 730-3085

July 17, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

Enclosed are six sets of this organization's comments with respect to the Technical Corrections Bill of 1987.

Should you wish to discuss this further or wish any expansion or clarification on our comments, please feel free to contact me.

Sincerely,

Albert G. Doumar

Albert G. Doumar
Chairman
Conference Committee

Enclosures

TECHNICAL CORRECTIONS BILL OF 1987

I. Application of 2% Floor to Trusts and Estates (Sections 101(f)(2), (3) and (4) of the Bill, Section 132 of the Reform Act, and Section 67 of the Code).

The Bill provides that the distribution deductions allowable to an estate or trust under Sections 651 and 661 of the Code are to be treated as allowable in computing the adjusted gross income of an estate or trust.

This provision creates a "Catch-22" situation in that you cannot compute the distribution deduction until you know the deductions allowable in calculating the entity's "Distributable Net Income" which would exclude the portion subject to the 2% floor. If you cannot compute your distribution deduction, you cannot compute the entity's "Adjusted Gross Income" and accordingly, the portion of the entity's deductions subject to the 2% floor.

Finally, under the provision, the Treasury has regulatory authority to apply the 2% floor at the beneficiary level, rather than at the entity level, to the extent that income is distributed to beneficiaries. This would be a meaningless allocation since net figures are advised out to beneficiaries and thus, under current law there is no provision for making the deductions subject to the 2% floor reportable by a beneficiary for regular income tax purposes.

II. Taxable Year of Common Trust Fund (Section 108(e)(5)(A) of the Bill and Section 584 of the Code)

A) The Bill provides that if a common trust fund is required to change taxable years, and as a result of such change a participant in such common trust fund is required to include items of income from more than one taxable year of the common trust fund in any of the participant's taxable years, the items of income from the short taxable year of the common trust fund may be included in income by the participant ratably over a four-taxable-year period.

The term "participant" needs clarification. Please note that technically the participant of a common trust fund is the trust or estate entity which has invested in the common trust fund and not its respective beneficiary. Since both the trust or estate and its respective beneficiary will experience "bunching of income" due to this mandated change to a calendar year, both should be accorded the option to report said income ratably over a four-taxable year period.

B) We strongly recommend that the statute should not be changed and that common trust funds be allowed to retain their current tax years.

Our arguments for a status quo are based on "hardship" rather than technicalities.

1. The processing of tax information for all trusts will be delayed a minimum of 30 days. This would be a result of having to first process the various funds so that figures could be fed into the participating accounts.

2. The delay in obtaining common trust fund tax information will make it more difficult to compute accurately and make timely payments of estimated taxes.

3. Providing beneficiaries with the required information (1041-K1) will be delayed accordingly (30 days plus) and result in more extensions of time to file.

4. Common trust funds are subject to an "outside" audit. Accounting firms will be hard pressed to satisfy this requirement since they will be faced with extremely heavy workloads immediately after year end.

5. Corporate fiduciaries already find their computer time at a premium at, and after, year end. This problem will be compounded.

If the status quo cannot be maintained, then in the spirit of addressing a supposed loophole without putting the undue hardships on corporate fiduciaries and respective beneficiaries in meeting with all tax administrative requirements that would stem from a mandated charge to a calendar year, we suggest the following alternatives.

1. Allow existing common trust funds to retain their current tax year and mandate that all new common trust funds, i.e. those created after December 31, 1986, adopt a calendar year; or

2. Mandating that all existing common trust funds adopt a tax year ending in September, October, November or December. The selection of any one of these fiscal years would involve minimal deferral.

III. Gifts of Appreciated Property - Items of Tax Preference. Section 107(c)(3) of the Technical Corrections to the Tax Reform Act of 1986, amendments related to title VII of the Reform Act, adds "or Section 642 (c)" to the reference already contained in Section 57(a)(6)(A) in Section 170.

The meaning of this addition is, at best, unclear. The purpose of the addition of Section 57(a)(6) to the 1986 Tax Reform Act was to capture as a preference item the untaxed appreciation on gifts to charity. However, this reference to the charitable contribution deduction allowable to estates and trusts overlooks a key difference between the manner in which charitable contribution deductions are allowable to estates and trusts and to individuals.

Individuals are entitled to a charitable contribution deduction under Section 170(c), and the charitable deduction for individuals of capital gain property is further limited by Section 170(b)(1)(c). However, while an individual is entitled to a charitable deduction for property given in kind to charity, the rules governing the charitable deductions of estates and trusts under Section 642 contain the basic distinction that charitable deductions are only allowed for amounts contributed to charity out of the estates or trusts "gross income" (see Section 642(c)(1) and (2)). An individual need not make a contribution out of income to generate such a deduction, and, as a result, treating the preference item created under Section 57(a)(6) accomplishes the desired legislative goal.

The expansion of this rule to cover the charitable contributions of estates and trusts is simply unnecessary. There is no charitable contributions deduction allowable to an estate or trust if the estate or trust does not first realize income (e.g., as a result of a sale, or of the receipt of an item of income such as a dividend) which is then, pursuant to the terms of the governing instrument, paid to (or, in the case of pre October 9, 1969 trusts, set aside for) charity.

It is recommended that this Technical Correction be deleted.

IV. Application of Capital Losses and Computation of Unused Carry-forward Losses. Sec. 301(b)(10) of the Reform Act amends Sec. 1211(b) of the Code and Sec. 301(b)(11) amends Sec. 1212(b)(2) Code.

The result of the above amendments is that a individual taxpayer (including estates and trusts) will be deemed to use up to $3,000. of a capital loss even if such taxpayer has no taxable income. Any carry-forward would be reduced accordingly.

We recommend that Sec. 1211(b) of the Code be amended to provide that, in the event of no taxable income, no loss would be allowable or deemed used, and the entire amount be carried forward under Sec. 1212(b)(2).

V. Annualization of a Trust's Taxable Income Re Mandated Converson From a Fiscal To A Calendar Year (Section 1403 of the Reform Act and Section 645 of the Code).

Under Section 443 of the Code, if a taxpayer's return is for a period of less than 12 months as a result of the taxpayer (with the approval of the Secretary) changing his annual accounting period, the taxable income for the short period shall be computed on an annualized basis.

Section 806 of the Reform Act which mandates the conversion to a calendar year re partnerships, S corporations, and personal service corporations, specifically states that "such change shall be treated as initiated by the taxpayer" (Section 806(e)(2)(A). Accordingly, Section 806(e)(2)(A) brings into play the requirements of Section 443 of the Code which mandates annualization of taxable income for the short taxable period.

In this regard, neither Section 1403 of the Reform Act (645 of the Code) nor the Technical Corrections Bill of 1987 contain language similar to Section 806 (e)(2)(A) of the Reform Act. Hence, one can properly conclude that the taxable income of a trust for its converted short calendar year does not have to be computed on an annualized basis since this change was not initiated by the taxpayer.

However, to make it clear that this was the intention of Congress, we suggest that the Technical Corrections Bill of 1987 amend Section 1403 of the Reform Act to indicate that Section 443 of the Code does not apply to this mandated conversion to a calendar year and further that the personal exemption be prorated.

If annualization is applicable, an inordinate amount of work would be created for trustees and the Internal Revenue Service. The following example illustrate the steps required under Section 443:

Assume a trust is currently on a January 31 fiscal year and the trustee (in accordance with the Act) adopts a calendar year. The short year ending December 31, 1987, contains 11 months (February 1 through December 31). Annualizing is accomplished as follows:

1. Determine taxable income, before exemptions, for the 11 months
2. Subtract 11/12 of the exemption (result is known as modified taxable income)
3. Multiply by 12
4. Divide result by the number of months in the short year (11)
5. Compute tax on amount from step 4
6. Multiply result by 11/12

The tax liability from step 6 would be remitted with the filing of the return on April 15, 1988.

The trustee must then wait until the original tax year is completed (January 31, 1988). He will then make the following two calculations.

A. compute the tax on the "modified taxable income" from step 2 above, and
B. compute the tax on the taxable income for the full 12 month period and multiply the result by

$$\frac{\text{modified taxable income for short period}}{\text{taxable income for entire year}}$$

If the larger of A or B exceeds the tax already paid, a claim for refund must be submitted for the excess.

The complexity of this entire exercise would be compounded by the alternative minimum tax, which would require another series of computations. Also bear in mind that these steps must be taken for each and every fiscal year trust.

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WRITTEN STATEMENT

David T. Wright
National Director of Tax Services
COOPERS & LYBRAND

On H.R. 2636, The Technical Corrections Act of 1987
July 17, 1987
Before The House Committee on Ways and Means

Mr. Chairman and Members of the Committee, I am submitting for the record suggestions for additional matters to be considered in regard to H.R. 2636, the Technical Corrections Act of 1987. This submission has been prepared on behalf of Coopers & Lybrand, an international accounting firm with more than 95 offices in the United States alone. The matters included here are issues that have come to our attention in the course of advising our clients on the many intricacies of the Tax Reform Act of 1986. Additional issues are likely to be discovered in the months ahead, and thus we hope that the tax writing committees will view the corrections process on this massive Act as an ongoing one.

Estimated Tax Payment Rules for U.S. Citizens Abroad

The Act added Section 6654(j) to The Internal Revenue Code to provide special estimated tax rules for nonresident aliens (Act Sec. 1841). These rules permit estimated tax payments for these taxpayers to be made in three installments, with the first due date on June 15 in the amount of 50% of the estimated tax liability. Subsequent due dates and payments are the same as apply to other taxpayers.

We recommend that this rule's application be extended to U.S. taxpayers residing abroad. These U.S. citizens face the same serious difficulties in receiving and compiling their tax records and calculating their tax liabilities, because they are working and residing abroad, as those faced by foreign individuals. Historically, the Internal Revenue Service has acknowledged this hardship. The regulations under Section 6081 grant these taxpayers an automatic extension, until June 15, for filing their tax returns.

Likewise, the estimated tax regulations under Section 6073 had allowed a similar extension until June 15 for payment of the first estimated tax installment by U.S. citizens abroad. However, Section 6073 was repealed in the 1984 Act as part of a consolidation and simplification of the estimated tax rules along with Sections 6015 and 6153. There was no intent on the part of Congress to change the estimated tax rules for U.S. citizens abroad. Nevertheless, the repeal of Section 6073 threw the status of the regulations into doubt. Since that time, for 1985 and 1986 tax returns, IRS has granted specific relief by allowing a two-month extension for the first estimated tax installment. However, this year, in their Announcement IR 87-50, dated April 9, 1987, the Service indicated that future administrative relief would not be provided. We believe the Service has taken this position not because they have lost sympathy with the plight of these taxpayers, but rather because their statutory authority for granting such relief administratively has been greatly weakened. Now that Congress has addressed a similar problem for non-resident aliens, while ignoring a more compelling need for U.S. citizens residing abroad, the Service must feel on thin ice indeed.

Accordingly, we believe legislative action is necessary to resolve this issue on a permanent basis. Our recommendation to extend Section 6654(j) to U.S. citizens residing abroad will simply insure that these taxpayers are not treated worse than foreign individuals in the United States.

Good faith attempts to meet an April 15 deadline for filing returns and estimated taxes would often fail, given the normal delays in mail delivery, greater complexities in preparing these returns because of foreign tax credits and special computations of such items as moving allowances and housing costs, and other difficulties in receiving tax documents from the United States and finalizing return preparation. Further, there would appear to be no compelling reason to deny this relief to U.S. taxpayers abroad, since 50% of the estimated tax liability would be paid on June 15. We hope the Committee will see fit to grant this relief.

Limitations on Net Operating Losses -- The Role of Old Section 382?

The Technical Corrections Act as introduced attempts to clarify when and to what extent the 1954 Code version of Section 382 ("old Section 382") continues to apply (see Section 106(d)(11) of the bill, page 39 of the Description). This effort is badly needed, but the result so far is less than fully satisfactory.

Section 382 limits the use of certain favorable tax attributes when a change in the beneficial ownership of those items occurs. We understand that the intent of the provision in the technical corrections bill is to clarify that old Section 382 will apply _only_ to transactions that are not covered by new Section 382 _because of_ a transition rule exception or other special treatment. On the other hand, a transaction that is subject to new Section 382 but does not result in a limitation should not be subject to old Section 382 after 1986. If this understanding is correct, it is not clearly communicated either by the statutory language or in the Description of the Technical Corrections Act. This area of the law is one where great uncertainty has existed for quite some time, and we believe, now that Congress has settled upon permanent rules here, every effort should be made to clear up ongoing ambiguities about how these rules should operate.

The Description does not mention the situations in which old Section 382 will not apply and does not express that old Section 382 should apply _exclusively_ in a transition rule situation. The statute is also unclear. The amendment to Section 621(f)(1) of the 1986 Tax Reform Act adds a paragraph (B) on "Termination of Old Section 382," which attempts to clarify the matter but fails because a clearer reference is needed to the ownership changes to which old Section 382 will not apply. Further, the period of continued application of old Section 382, after 1986 until January 1, 1989, should also be clarified.

Illustration: The following will illustrate the type of case not clearly addressed by the Act or the Technical Corrections legislation as introduced.

> Suppose Individual A buys exactly 50% of the stock of L, a loss corporation, from Individual B. It is A's intention to have L change its business in the near future. Under old law (pre-1986 Act), L's NOLs would be completely extinguished (under old Section 382(a)) as a result of this transaction. But under new law (Section 382 as enacted by Section 621 of the 1986 Act), the special limitation on NOL utilization does not apply because A did not buy _over_ 50% of L's stock from B (new Section 382(g)).

> Thus, new Section 382 does not present a problem. The question is whether old Section 382(a) might continue to be effective and thereby operate to extinguish L's NOLs; note that new Section 382 is inapplicable by its terms and not because of an effective date cr transitional rule.

We recommend that the intended application of the 1986 Act to this type of case be further clarified.

Treatment of Certain Transferees Under Modified ACRS -- Effective Date Problem

Code Section 168(i)(7)(B) now provides that the rule of prior law permitting a transferee to step into the shoes of the transferor for computing cost recovery deductions no longer applies in the case of a termination of a partnership under Section 708(b)(1)(B) -- terminations that result from a sale or exchange of 50% or more of the partnership interests within a 12-month period. This rule was retroactive to terminations occurring after December 31, 1985 (Act Sec. 1809). The intention was that the new half-year convention rule would apply in such cases to provide both the transferor and the transferee a depreciation allowance for one-half of the year in the year of deemed disposition. However the half-year convention rule does not apply until after December 31, 1986 under the modified ACRS system. Hence, a question has arisen concerning the intended effect of these provisions on depreciation deductions for tax years ending after December 31, 1985 but before January, 1987.

We recommend that this effective date problem be solved by applying the half-year convention rule to these transactions occurring in 1986 or by providing a special rule for 1986 that allocates the allowable depreciation between the original partnership (transferor) and the reformed partnership (the transferee) based on the number of months in the tax year that each held the property.

Full Basis Adjustment on Transition ITC -- A Problem of Application for Transactions Subject to At-Risk Rules

Under new Code Section 49(d), if a partnership or S corporation owns an asset entitled to the transition ITC, the partnership or S corporation must reduce the basis of the asset by the full amount of the credit allowable, whether or not the individual partners or S corporation shareholders are actually allowed to claim the credits on their tax returns. The Technical Corrections Act makes clear that, if such a credit is recaptured, there will be an upward basis adjustment for the amount recaptured and that, if such a credit expires unused at the end of the carryforward period, a deduction will be allowed for 100% of the unused credit (bill Section 102(e), Description page 13).

The essence of the solution provided in the technical corrections bill is that, if all else fails, wait 15 years for the carryforward period to expire and finally a proper adjustment will be made. We believe this solution is inadequate. In cases such as transactions to which the at-risk rules apply to deny the credit to individual investors, the relief provided by the introduced bill is just not timely. A much better solution would be to allow the adjustment when the asset is disposed of.

We recommend that a basis adjustment should be provided for these unused credits when the asset is disposed of. This approach is similar to that under the rules adopted for passive losses and would constitute a much fairer result for affected taxpayers.

Definition of Material Participation for Closely Held High Technology Companies

Section 469(c)(5) includes within the definition of trade or business any activity involving research or experimentation within the meaning of Section 174. Section 469(h)(4) defines material participation for a closely held C corporation or personal service corporation as situations where (i) one or more shareholders holding more than 50% of the stock materially participate, or (ii) the requirements of Code Section 465(c)(7)(C)(i)-(iii) are met. Code Section 465(c)(7)(C)(i)-(iii) in turn imposes a three-part test to define an active business. These tests look to (i) the number of full-time employees in management; (ii) the number of employees performing services for the business; and (iii) whether the amount of deduction attributable to such business and allowable under Section 162 and Section 404 exceeds 15% of the gross income of the business.

Our concern arises because the test under Section 465(c)(7)(C)(iii) does not include research and experimentation expenses under Code Section 174 or start-up expenses under Code Section 195. In developing and bringing to market new products, many high technology and research companies incur significant Section 174 expenses as well as start-up expenses under Section 195; the Section 162 expenses may be minimal during their early years. These companies are, in fact, active businesses, but because of the nature of the expenses incurred, they might fail to satisfy the active business test in Section 465(c)(7)(C)(iii).

We do not believe that Congress intended to so adversely affect high technology start-up ventures under Section 469, particularly not after the effort in the 1986 Tax Reform Act to clarify the treatment of R&E expenses.

We recommend that the technical corrections legislation address this problem by amending Section 469(h)(4)(or Section 465(c)(7)(C)) to include any expenses under Section 174 for research and experimentation, or under Section 195 for start-up expenses, as expenses that qualify under these active business tests, along with Section 162 expenses.

Failure to address this issue will cause some high technology start-up companies to fail the material participation test of Section 469(h)(4). The tax result of such failure would be that taxes would accrue on any interest income earned on the firm's venture capital, even though the firm was not operating at a profit. This would occur because the interest income would be considered portfolio income, while the business and its other expenses would be characterized as a passive activity resulting in passive losses. Many potentially affected companies are presently unaware of this issue because it is the end result of interactions between a number of separate provisions. I have no doubt that you will hear more about this matter as the year progresses.

Conclusion

Mr. Chairman and Members, that concludes my statement. To reiterate, we believe a credible job has been done to date on technical corrections, and we have but a few issues worthy of raising to your attention today. However, I would reiterate that we view the task of perfecting the 1986 Tax Reform Act as necessarily requiring an ongoing process, and we hope that the Committee will adopt this view as well. As we practitioners deal more with specific client questions and fact patterns, we gain more experience with the 1986 Tax Reform Act -- its provisions, its gaps, and its flaws, if you will. I expect that we will be back here next summer with additional recommendations, after we grapple with the new law in a return-preparation environment and as we generally gain more experience with it.

Thank you for your attention to these matters. If you have any questions, please feel free to call on me at 822-4262 or Pamela Pecarich, a partner in our National Tax Services office, at 822-4239.

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FINANCE DEPARTMENT
TAX DIVISION

August 3, 1987

Mr. Robert J. Leonard
Chief Counsel
1102 Longworth House Office Bldg.
Washington, DC 20515

Dear Mr. Leonard:

The following are our comments on H. R. 2636, the proposed "Technical Corrections Act of 1987" (the Act).

- The look-through rules in Section 904(d)(3) of the Internal Revenue Code of 1986 (the Code) should be clarified by the Act to provide that they apply to interest, rents, and royalties received by a controlled foreign corporation from a brother/sister corporation which is a related controlled foreign corporation or 80/20 company (or vice-versa).

- At page 397 of the Senate Finance Committee Report on the Tax Reform Act of 1986, it is made clear that the Passive Foreign Investment Company provisions in Sections 1291 through 1297 of the Code were not intended to apply to a controlled foreign corporation (as defined in Section 957(a) of the Code) which is governed by Subpart F of the Code. The Act should include a provision modifying the Code to reflect this intent.

- Section 463(a)(1) of the Code as amended by the 1986 Tax Reform Act allows an accrual basis taxpayer to take a deduction for vacation pay earned by employees before the end of a taxable year provided it is also paid within 8 1/2 months following the close of the taxable year. A simplified method is needed to compute the amount paid within 8 1/2 months following the close of the taxable year as many corporate accounting systems do not make that data available. As most vacations are taken by September 10 of each year, the adoption of a rule creating a presumption that 17/24ths of the yearly vacation accrual are paid within 8 1/2 months following the close of the taxable year is reasonable. The Act should amend Section 463 to include such a rule for calendar year taxpayers.

Very truly yours,

Wm. Resnick

William Resnick
Director

Emergency Committee for American Trade 1211 Connecticut Ave Washington DC 20036 (202) 659-5147

July 13, 1987

Mr. Robert J. Leonard
Chief Counsel
Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Rob:

At the request of Ways and Means and Finance staff, the Emergency Committee for American Trade (ECAT) informally circulated in the spring the suggestions of its members as to technical corrections. In response to Chairman Rostenkowski's recent request for written comments by July 17, we thought it might be useful to resubmit our comments for the record.

We also wanted to bring to your attention an issue which is very important to ECAT member companies, and which in some ways has developed since our earlier submission. This issue concerns the characterization of active, bona fide U.S. businesses as passive foreign investment companies (PFIC). The PFIC rules were intended to cover foreign mutual companies and other passive foreign investment funds. Both the House and Senate bills specifically provided that CFCs would not be subject to the PFIC rules. Not only are CFCs the usual means by which American businesses compete abroad, but they are already subject to the full coverage of Subpart F.

Inexplicably, however, the final bill did not include the language passed by both the House and Senate. Most people assumed this was a technical error. Various IRS, Treasury, and other officials stated in public discussion that it would be "fixed" in the technical corrections bill. Unfortunately, the proposed technical corrections bill does not do this. The proposed bill does eliminate some but not all of the consequences of being characterized as both a CFC and PFIC. But it does not eliminate the basic overlap.

We think it is imperative that the technical corrections bill make it clear that a CFC will not also be subject to the PFIC rules. The complexity and unfairness the CFC/PFIC overlap adds to the Code, in addition to the adverse effect it will have on American companies retaining capital and competing abroad, far outweigh the minimal revenue pick up involved. If complete elimination of the overlap is not possible, the overlap should be narrowed -- for example, by requiring a CFC to meet both PFIC tests (asset and gross income) before it will be characterized as a PFIC.

If you have any comments or questions on the CFC/PFIC issue or the other issues discussed in the attached, please feel free to call me or our tax counsel, Ray Wiacek, at Jones, Day, Reavis & Pogue (879-3939).

Best regards.

Sincerely,

Bob

Robert L. McNeill
Executive Vice Chairman

Emergency Committee for American Trade 1211 Connecticut Ave Washington DC 20036 (202) 659-5147

Suggested Technical Corrections to TRA 1986 Foreign Tax Provisions

1. Sections 904(d)(1)(B) and 904(d)(3)(C) -- Interaction of High Withholding Tax Interest and Look-Through Rules. Section 904(d)(1)(B) creates a separate foreign tax credit limitation for high withholding tax interest (interest subject to withholding of 5% or more). Section 904(d)(3)(C) provides a look-through rule under which interest received from a controlled foreign corporation ("CFC") in which the taxpayer is a U.S. shareholder will be characterized for section 904 purposes by reference to the income of the CFC. If the interest payment from the CFC is subject to a withholding tax of 5% or more, however, it is not clear which of these rules will control. A priority rule should thus be provided.

2. Export Financing Interest. Export financing interest generally is intended to be placed in the overall limitation of section 904(d)(1)(I). However, the interaction of the look-through rules of section 904(d)(3) and the deduction allocation rule of section 954(b)(5) may cause a contrary result. It is possible that under these rules a CFC's export financing interest will be placed in the passive income limitation (because under section 954(b)(5), any interest that the CFC pays to its U.S. shareholders must be allocated first to the CFC's passive income). This result would largely vitiate any effect that the export financing exception could have. The statute should thus be corrected to prevent this result.

3. Section 904(d)(3) -- Application of Look-Through Rules to Foreign Payees. The section 904(d)(3) look-through rules apply to amounts "received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder". The rule technically may not

apply, however, to payments received by one CFC from a second CFC (even where the taxpayer is a United States shareholder in both CFCs). It is believed that the look-through rule was intended to apply to such payments. Thus, the statute should be clarified to this effect.

4. Allocation of Deductions/Credits. Section 904(d)(3) provides that items of income, including dividends, interest, rents, and royalties and Subpart F inclusions are subject to the separate basket limitation depending on the nature of the income in the hands of the payor (CFC). The statutory provision does not provide guidance as to how the proper allocation of tax deductions or credits associated with items subject to the look-through rules is to be made. Clarification should be provided by which the proper allocation of tax credits and deductions associated with items of income subject to the look-through rules can be made. If the various types of income subject to the look-through rules have been taxed at different effective rates, it will be necessary to provide tracing rules so that the tax deductions and credits associated with a particular category of income tax can be attributed to the proper separate basket. If tracing is not possible, foreign taxes will have to be averaged and then allocated among the separate baskets.

5. Section 954(b)(4) -- Computation of Effective Tax Rate. Section 954(b)(4) provides that an item of income received by a CFC will be excluded from Subpart F foreign base company income and insurance income if the taxpayer establishes to the satisfaction of the Secretary that the income was subject to an effective foreign income tax rate which was greater than 90 percent of the maximum U.S. rate. The term "effective" rate is not defined and it is unclear whether the "item of income" on which such effective rate is calculated is determined based upon U.S. concepts or foreign concepts. Nor is it clear what the impact is of a temporary reduction in local tax (e.g., local tax credit, local net operating loss). Clarification should be provided concerning all of these points.

6. Section 955(a)(2)(A). Section 955(a)(2)(A) refers to qualified investments "at the close of the last taxable year beginning before 1987" (hereafter, "December 31, 1986"). The section thus may be interpreted to require that the amount of each year's withdrawn previously excluded shipping income ("withdrawn income") be computed as the difference between the amount of qualified investments on December 31, 1986, and the amount of qualified investments at the end of each year thereafter (as limited by section 955(a)(1)). This interpretation would cause a substantial acceleration in the withdrawal of previously excluded shipping income because the computation of the withdrawal for each post-1986 taxable year would always be made by comparison to the taxpayer's qualified investment on December 31, 1986. The appropriate result should be that the amount of withdrawn income in any year should not be greater than the difference between the qualified investment on December 31, 1986, reduced by the amount of income withdrawn thereafter, and the qualified investment at the end of the post-1986 year at issue.

7. Translation of Taxes. Section 986(b)(1)(B)(ii) provides that refunds and credits of foreign tax are to be translated using the "exchange rate as of the time of original payment" of the foreign tax. However, it is normally impossible to trace a refund to a particular "original payment" of tax. Consequently, where no tracing is possible, the phrase "exchange rate as of the time of original payment" should be clarified to mean the weighted average exchange rate for all taxes paid for the year to which the refund or credit relates. In the alternative, the phrase should be defined as the dates upon which estimated tax payments were made for the year to which the credit or refund relates, with a first-in, first-out rule to apply.

Section 986(b)(1)(B)(i) requires that adjustments other than refunds or credits are to be translated using the appropriate exchange rate "as of when such adjustment is made". This phrase could be construed to mean (1) the date of accrual of the adjustment, or (2) the date actual payment is made on the adjustment. For purposes of adjustments resulting in tax increases, the Conference Report (at 672) states that the appropriate date of translation is the date of payment. The proper date for any other adjustments (e.g., interest) should be clarified (with the date of actual payment being the preferred method).

8. Section 986(b)(2) -- In Lieu of Taxes. Section 986 provides rules to determine the U.S. dollar amount of foreign income taxes paid by a foreign corporation for purposes of sections 902 and 960. The term "foreign income taxes" as defined in section 986(b)(2) does not currently include section 903 "in lieu of" taxes. Section 903 or section 986(b)(2) should be amended to provide that for purposes of Subpart J, the term "income, war profits or excess profits taxes" includes a tax paid in lieu of such taxes otherwise generally imposed by any foreign country or by any possession of the U.S.

9. Section 312(k)(4). TRA 1986 deleted the last sentence of section 312(k)(4), which had provided that the rules of pre-TRA 1986 section 168(f)(2) apply in computing the earnings and profits of foreign corporations less than 20 percent of whose income is derived from U.S. sources. It is not clear what rules now apply. Section 312(k)(4) seems to provide that the straight line method is not used (because it states that section 312(k)(1) is inapplicable). However, the successor to pre-TRA 1986 section 168(f)(2) (section 168(g)(1)) could be read still to apply (despite the deletion of the last sentence of section 312(k)(4)) -- and it provides for use of the straight line method.

10. Section 168(d)(3). Section 168(d)(3) generally provides that if the aggregate basis of property placed in service during the last 3 months of the taxable year exceeds 40% of the aggregate basis of all property placed in service during the taxable year, a mid-quarter convention (rather than a half-year convention) shall apply. The Conference Report

states that for purposes of this provision all members of an affiliated group (including foreign corporations) will be treated as one taxpayer. This requirement is not included in the statutory language of section 168(d)(3). It is possible that by aggregating domestic and foreign assets, the midquarter convention may be applied to U.S. assets which would not exceed the 40% test if they were not aggregated with the foreign assets. This does not appear to be the legislative intent. In addition, the true impact of the rule on foreign corporations is on the computation of earnings and profits. Quaere whether the significant recordkeeping inconvenience caused by the rule in such cases is worth the revenue (if any) that will be generated (particularly since, for section 902 and 960 purposes, earnings and profits will now be computed on a "pool" basis)?

11. Section 59A. Section 59A imposes an environmental tax on modified alternative minimum taxable income ("Modified AMTI"). The computation of Modified AMTI begins with a corporation's regular taxable income, which includes its section 78 gross-up of foreign taxes deemed paid by the corporation. No foreign tax credit is allowed against the section 59A tax. Thus, section 59A as presently drafted in effect requires the environmental tax to be paid on foreign taxes deemed paid by the U.S. taxpayer. This result should be changed.

12. Section 263A. Section 263A provides for the capitalization or inclusion in inventory of specified costs. Because post-1986 earnings and profits will be pooled for foreign tax credit purposes, the revenue impact of this provision on foreign subsidiaries should be minimal. By contrast, the additional administrative burden created by the provision will be significant, particularly when added to the multiplicity of reporting requirements and formats to which foreign subsidiaries are already subject (i.e., local tax, local statutory, U.S. tax, U.S. accounting, and management reporting). It is thus apparent that the section 263A

administrative burden imposed in respect of foreign subsidiaries will be disproportionate to any ends that are achieved. Therefore, an exception to the application of section 263A should be created for purposes of computing the earnings and profits of foreign subsidiaries. (We note that the IRS has stated in connection with its recently issued temporary regulations under section 263A that the regulations apply to foreign subsidiaries and that "further detailed guidance" will be forthcoming in this regard.)

13. Foreign Taxes Paid To A Possession. Section 56(f)(2)(F)(ii)(1) provides that 50 percent of any withholding tax paid to a possession of the United States with respect to dividends that are added to adjusted net book income is treated as a creditable foreign tax paid by the corporation receiving the dividends. In some cases, dividends from Puerto Rican subsidiaries are not subject to a withholding tax (because the recipient is engaged in trade or business in Puerto Rico), although the dividends are subject to the regular corporate Puerto Rican income tax at a reduced effective rate. The effective rate on such dividends approximates the withholding tax rate. A clarification or technical amendment should provide that all Puerto Rican income taxes on dividends are creditable foreign taxes for alternative minimum tax purposes.

14. Section 56(f)(2)(C)(ii)--Foreign Sales Corporation Dividends. Section 56(f)(2)(C)(ii) literally requires all dividends from foreign sales corporations ("FSCs") to be included in book income for purposes of computing the book income adjustment to taxable income. However, the Conference Report (at 271) provides that excludable foreign sales corporation income is to be treated as under present law -- *i.e.*, as not being a preference item. In addition, to the extent dividends from FSCs are attributable to earnings that have been treated as effectively connected income under section 921(d), their treatment as a preference item is unwarranted. Dividends from FSCs should thus be excluded from book income.

GEORGE W. GEKAS, M.C.

COMMENTS ON H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

Mr. Chairman, due to the fact that the Ways and Means Committee's schedule on the Reconciliation Bill precludes a public hearing on H.R. 2636, I appreciate being given the opportunity to present in writing my comments on H.R. 2636, the Technical Corrections Act of 1987.

Now that some time has passed since the Tax Reform Act became law, I believe that the implications of these changes are finally being realized. It is apparent to me that many of the far-reaching changes incorporated in the Tax Reform Act, while implemented with good intentions, may have consequences that could seriously affect in a negative manner certain select groups. I would like to address several of these changes which I feel are most in need of correction yet are not addressed in H.R. 2636, the Technical Corrections Act of 1987.

The Tax Reform Act changes many of the provisions that affect the way farm income is taxed, although it does leave intact some of the tax preferences accorded farm income. One of these changes found in the Tax Reform Act that is not addressed in the Technical Corrections Bill is the elimination of income averaging for farmers.

I agree that it cannot be argued that income averaging was often abused, allowing many individuals to avoid paying taxes on income that should have been taxed. However, I believe that income averaging, in certain situations, allowed farmers to remain in business in times when without this tool it would have been more difficult for them to survive. Such an example is when a farmer suffers a natural disaster for one or more years at a time.

I believe that changes should be made in H.R. 2636 to allow income averaging for those farmers whose farms have suffered a natural disaster. This would allow a farmer to protect himself in those instances when the loss of a crop due to floods or some other unpredictable incident has greatly reduced crop yield, and consequently his income, during a given year.

The revenue loss to the government because of these changes would be minimal since it is estimated that only 10 percent of farmers' tax returns have used income averaging in past years. The number would be further reduced because the percentage of farmers affected by this legislation would be tied to the incidence of natural disaster. Yet the difference in the amount of income tax which that small percentage of farmers would have to pay could allow them to survive those unfortunate incidents of natural disaster which might otherwise have the potential to destroy them.

Therefore, I respectfully submit that it is essential to the farmers of our country, who were having difficulties prior to the elimination of this useful tool, that the use of income averaging for farmers who have suffered a natural disaster be restored.

I would also at this time like to comment on another provision of the Tax Reform Act which was also not addressed in the Technical Corrections Bill of 1987. I am particularly concerned about the impact of the provision of the Tax Reform Act of 1986 which requires partnerships, S corporations and personal service corporations to adopt the same taxable year as their owners.

I understand that this provision was originally added in the Senate to stop what appeared to be a serious tax avoidance problem. However, I believe that this provision is unworkable and unnecessary. The requirement creates significant hardship for small business owners and places great burdens on our tax-assessment system. It will also, I believe, cause mayhem in CPA firms during the January through April tax season and will place an unreasonable burden on the Internal Revenue Service which is already having difficulty coping with the "tax crunch" that occurs during the first four months of every year. I also believe that this provision reduces necessary flexibility in structuring business transactions.

I appreciate the Committee's concern that elimination of this provision would appear to present a general revenue problem, which was such an intrinsic part of the reform. I believe, however, that alternatives to total repeal of this provision exist which would still achieve the tax policy goals of this provision while alleviating the burdens on the tax accounting profession. One such proposal would permit most partnerships, personal service corporations and S corporations to retain their fiscal years, provided they make enhanced estimated tax payments to offset any tax deferral which may result from the mismatch between the tax years of the entities and owners. This would permit taxpayers to retain a tax year that suits their business needs, while eliminating any resulting tax deferral. This alternative proposal is simple enough to be of real value and it does not shift the burden of compliance to other groups of taxpayers on whom that burden should not lie.

I would respectfully submit that your committee carefully review such an alternative and consider its inclusion in the Technical Corrections Act of 1987.

I feel it necessary to express my strong support for another provision, one that is addressed in the Technical Corrections Act of 1987: the taxation of pre-annuity lump-sum distributions. As you know, when the tax law was being written an exception was drafted for state and local employees' retirement plans. However, because of the language included in this exception, the public employee retirement plans in Pennsylvania, Hawaii and Michigan were excluded. This was clearly an unintended effect.

I was pleased to see that the Technical Corrections Act of 1987 includes a provision that would correct the language that would have taxed pre-annuity lump sum distributions of Pennsylvania public employees and was particularly pleased to see that this provision will be "grandfathered" in so that it will retroactively include all those individuals who would have been negatively affected by this matter.

It is my hope that as the Ways and Means Committee continues to act on the Technical Corrections Bill consideration will be given to the very important changes suggested above.

Mr. Chairman, in closing I must once again thank you for providing me with an opportunity to express my views on these very important matters and would greatly appreciate your consideration of them.

GOVERNMENT FINANCE
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Comments of the
Government Finance Officers Association (GFOA)
on H.R. 2636
The Technical Corrections Act of 1987*

A professional organization representing 11,000 state and local officials and other finance professionals involved in all the disciplines comprising public finance, the Government Finance Officers Association (GFOA) is pleased to present these comments on the Technical Corrections Act of 1987 for consideration by the House Ways and Means Committee. While we disagree in substance with provisions enacted in the Tax Reform Act of 1986 affecting the financing of state and local government facilities, we have limited our comments to technical concerns.

GFOA opposes any attempt to overturn the City of Tucson decision in the Technical Corrections Bill.

A June 12, 1987 decision of the U.S. Court of Appeals for the District of Columbia Circuit, City of Tucson, Arizona v. Commissioner of Internal Revenue, overturned U.S. Treasury Department sinking fund regulations. The rules which provoked a firestorm of criticism by state and local governments when introduced in 1978 were criticized by the Court as being at odds with the underlying statutory precept. Congressional staff members have been quoted in the press recently as supporting a reversal of City of Tucson in the pending Technical Corrections Bill. GFOA strongly urges Congress to resist any recommendation to overturn the invalidated sinking fund regulations as part of the Technical Corrections Bill as it is not a matter for technical correction.

Briefly, Treasury sinking fund regulations define as "bond proceeds" any state or local government tax receipts or other revenues such as revenues from the sale of property or a favorable judicial judgment that are held in a sinking fund (a debt service or other type of fund a state or local government borrower expects to use to pay principal or interest on an issue). By making this designation, the investment of these sinking funds until they are needed to repay bonds outstanding is severely restricted because they are subjected to the arbitrage limits that apply to bond proceeds that have not been spent.

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*Prepared by Catherine L. Spain, Director, Federal Liaison Center, Government Finance Officers Association, 1750 K Street,NW, Suite 200, Washington, DC 20006, (202/429-2750). Questions or additional information concerning the issues presented in these comments should be directed to Ms. Spain or Cathie Eitelberg, Assistant Director of the Federal Liaison Center.

To avoid both imposing undue restrictions on state and local governments and the development of potentially abusive forms of transactions, any changes in this area should only be made after public hearings and careful deliberations including establishment of a consultation process with representatives of state and local governments. It is important for Congress to consider the cause of discontent on the part of state and local governments with the sinking fund regulations as well as the excessive breadth of the regulations which the Court reversed. GFOA realizes there may be matters of valid concern to which the proposed regulations relate. Nevertheless our membership has taken the position that the regulations imposed by Treasury were overbroad and failed to take into account traditional state and local practices of sound fiscal management.

We believe the sinking fund problem is similar to the issue surrounding Footnotes 160 and 173 in the Joint tax Committee "Blue Book" which is discussed below. GFOA has written to Treasury Secretary Baker offering to assemble a panel of state and local officials to advise on forthcoming arbitrage regulations implementing the 1986 Tax Reform Act provisions and Footnotes 160 and 173. We believe this would be an appropriate forum to discuss revisions to the sinking fund regulations.

GFOA supports adding a provision to the Technical Corrections Bill that would fulfill Congressional intent regarding the State and Local Government Series (SLGs) Program.

Section 1301 of Tax Reform Act of 1986 directed the U.S. Treasury to modify the State and Local Government Series (SLGs) program by providing issuers with instruments allowing flexible investment of bond proceeds in order to eliminate the earning of rebatable arbitrage. The Government Finance Officers Association has reviewed these regulations and finds that they fail to meet the intent of Congress to provide a flexible and administratively simple alternative to the arbitrage rebate. We have identified two aspects of the regulations that must be changed in order to rescue the program.

Specifically, GFOA recommends that the prohibition in the proposed regulations that prevents an issuer from mixing investments between the demand-deposit and time-deposit SLGs programs be changed. To remedy this problem we propose that Treasury permit issuers to make a one-time, up-front declaration of a split between the respective percentages of the bond proceeds they desire to be invested in demand-deposit SLGs and time-deposit SLGs. This approach gives the state or local cash manager the flexibility required for project financing without disrupting the U.S. Treasury Department's cash management operations because the total amount of funds available and the cash flows will be reasonably predictable. Further, it can be argued that this approach is even more predictable than the one proposed in the regulations because there will be fewer early redemptions by issuers who have failed to accurately predict their cash requirements. As envisaged, as time-deposit securities matured, they could be rolled over into the demand-deposit program. Additionally, if an issuer's demand-deposit balance was too high, an issuer could invest those proceeds in the time-deposit program, consistent with the notification and other rules of that program.

The formula designed by the Treasury for determining the weekly interest rate on demand-deposit securities results in a rate that is unacceptably low. The viability of the program hinges on issuers' ability to earn an adequate return on their investments. As proposed, issuers will earn a rate that is less than the tax-exempt rate at which they borrowed. Our recommendation is for Treasury to set a rate that is an index of short-term municipal rates and is not further reduced by an administrative fee. The use of such an index would preclude the need to adjust the derived rate by an "average marginal tax rate." We believe such a rate can be constructed easily based upon data reported in the Bond Buyer or other publications and will adequately cover Treasury's administrative costs. We reject the use of the fed funds rate as a base for the formula proposed by Treasury because of its inappropriateness under certain market conditions.

Since the Treasury Department has not yet modified the program to respond to our objections and fulfill Congress' intent we endorse a technical correction to assure that state and local government bond issuers will be able to avoid the overly complex and costly recordkeeping and computational requirements of the arbitrage rebate requirement.

GFOA supports adding a provision to the Technical Corrections Bill to exempt state and local governments from the mandatory distribution rule.

Section 1121 of the Tax Reform Act of 1986 repealed one of two criteria that had been in the federal tax code governing the timing of the distribution of pension benefits to employees. Under prior law, distributions were required to begin on the April 1st of the calendar year following the calendar year in which (1) the employee attained age 70 1/2 or (2) the employee retired, whichever was later. The second criterion has been repealed.

This tax reform provision was intended to preclude highly compensated private sector employees from using a pension plan as an estate planning device rather than for retirement purposes. This practice resulted in the avoidance of or reduction in taxes. However, state and local government systems operate under laws which prevent retirement benefits from being used in this way.

The new distribution requirement creates both policy and administrative burdens for state and local government retirement systems. Moreover, when this tax act change is viewed in light of two 1986 amendments to the Age Discrimination in Employment Act (ADEA), the problem is further complicated. These two provisions prohibit an employer from establishing a mandatory retirement age and from using age as a criterion for stopping retirement plan benefit accruals. We support a technical correction because

- The combined result of the three provisions is that an individual who has reached the mandatory distribution age (approximately age 71) and continues to work would simultaneously (1) collect a salary, (2) collect a retirement benefit, and (3) continue to accrue additional future retirement benefits. This scenario is further complicated as it can continue indefinitely because of the repeal of a mandatory retirement age.

- This federal distribution rule conflicts with state and local laws. Most states and scores of cities and counties prohibit employees from collecting both a retirement benefit and a salary. This practice, which is referred to as "double-dipping," is prohibited on public policy grounds and is similar to federal laws which restrict this practice in its workforce.

- Noncompliance with the federal law results in an extremely harsh penalty for the participant and jeopardizes the plan's tax-exempt status. A 50 percent nondeductible excise tax is levied on the amount which should have been distributed and is to be paid by the employee.

The Technical Corrections Bill should exempt state and local government workers from this provision because it disrupts sound state and local policy, creates extraordinary cost and administrative burdens on pension plans and undermines the intent of the repeal of a mandatory retirement age by making workers choose between giving up their job or paying tax on monies never received.

GFOA supports the inclusion of language in the Technical Corrections Bill clarifying that Section 457 of the Internal Revenue Code does not extend to nonelective deferred compensation.

Section 1107 of the Tax Reform Act of 1986 extended Internal Revenue Code Section 457 rules limiting elective deferred compensation plans to certain tax-exempt organizations. Section 457 as enacted in 1978 formerly applied only to the deferral of compensation by employees of state and local governments.

Since the passage of the Tax Reform Act, the Internal Revenue Service has taken the position in Notice 87-13 that the types and nature of deferred compensation plans governed by Section 457 also includes nonelective deferred benefit plans which generally had been thought to be outside the scope of the Section 457 rules. Examples of nonelective benefits plans could include vacation, sick time, and other benefits. The position adopted by IRS is inconsistent with the statutory language in the Tax Reform Act and the conference report accompanying the Act. No indication is given of Congressional intent to expand the type or nature of plans covered by Section 457. Additionally, the Joint Tax Committee's General Explanation of the Tax Reform Act of 1986 confirms our position that no change was made in the type or nature of deferred compensation plans subject to Section 457 rules. It states that 457 "continues to apply to the same types of deferred compensation to which it applied under prior law." (p.654)

GFOA supports a statement by Congress that Section 457 is not intended to apply to nonelective deferred compensation. If the IRS interpretation prevails state and local government employers would confront administrative nightmares coordinating elective and nonelective deferred benefit plans if both types of deferrals were subject to Section 457 limits. Furthermore the IRS position would result in state and local employees paying income taxes on a current basis for nonelective deferred benefits. This treatment is totally at odds with the history of federal income taxation where individual taxpayers are taxed on a cash-basis rather than an accrual-basis method of accounting.

GFOA supports the inclusion of a provision in the Technical Corrections bill clarifying that Footnotes 160 and 173 in the Joint Tax Committee's "Blue Book" do not reflect Congressional intent.

Two footnotes (numbers 160 and 173) in Joint Tax Committee's General Explanation of the Tax Reform Act of 1986 (the Blue Book) contained unexpected and overly broad interpretations of the new arbitrage provisions. The first provides that excess tax receipts invested in a bond reserve fund are to be rebated to the Treasury. The example given involves a general tax levy to pay debt service on governmental bonds. Because some of the taxes may be paid late, additional (or excess) taxes may have to be assessed to cover possible shortfalls. The footnote directs Treasury to treat those tax receipts not used to pay debt service as a reserve subject to the general arbitrage rebate requirement.

The second footnote instructs Treasury to require governmental units to treat certain funds as being available to an issuer if restrictions on the fund were established by the issuer or the issuer has the power to alter the use of the fund. This means that issuers of short-term tax and revenue anticipation notes would have to factor in funds traditionally unavailable when calculating their expected annual cash-flow deficit. For example, funds set aside for self-insurance reserves may have to be considered available for operating purposes.

GFOA believes that these footnotes are beyond what Congress intended. Further, it supports the addition of language in the Technical Corrections Bill clearly indicating that (1) excess tax receipts in a debt reserve fund should not be subject to the arbitrage rebate requirement and (2) state and local governments should not be required to consider funds set aside for nonoperating purposes to be available to meet current expenses when sizing their short-term borrowings for cash-flow deficit purposes. Examples are self-insurance and pension funds.

GFOA proposes that Congress correct an inconsistency in its treatment of small issuers by modifying the newly mandated information reporting requirement.

Section 1301 of the Tax Reform Act of 1986 requires issuers of tax-exempt bonds to report each transaction to the Internal Revenue Service. For purposes of the Act the term "bond" also includes leases, loans and short-term note issues. This requirement is especially burdensome for small governments that do not finance their capital equipment by going to the municipal bond market and obtaining the services of bond counsels who will ensure that they comply with the new requirement. Small borrowers often obtain their needed financing from local financial institutions in the form of a loan and without the benefit of a federal tax code expert assisting in the transaction. Failure to report carries a stiff penalty--retroactive taxability of the interest earned on the debt.

We recommend that this reporting cost burden be reduced by permitting small issuers (not more than $10 million in tax-exempt financing per annum) to fulfill the requirement by simply certifying to IRS they have issued no more than $10 million rather than reporting their financings. This treatment is consistent with the Tax Reform Act provision permitting small issuers to sell up to $10 million of tax-exempt bonds annually which are eligible for the bank interest deduction. The bank deduction provision recognizes the needs and limitations of smaller issuers and was included to reduce financing cost burdens.

July 10, 1987

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[redacted]

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June 30, 1987

File No. 170

HAND DELIVERED

Robert Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, DC 20515

Dear Mr. Leonard:

Re: Technical Corrections Act of 1987

The purpose of this letter is to request two additions to the Technical Corrections Act of 1987.

1. Correction to Section 1532 of the Tax Reform Act of 1986.

This section increases the penalty for failure to register a tax shelter to one percent of the aggregate amount invested in the tax shelter.

This penalty can be a very large amount, $500,000 on a $50,000,000 offering. In egregiously abusive cases such penalty could be warranted. However, there are many cases where reasonable minds can differ on the meaning of the statute and the Temporary Regulations are so broad that they create traps for the unwary. For example, though no quantification of tax results are presented from which any inference, let alone a reasonable inference, of a tax shelter ratio can be drawn, the mere inclusion of a tax opinion in the offering material is made enough to require registration by Temporary Regulation §301.6111-1T A-8 and A-9. On the other hand, the federal securities laws would require a discussion of tax implications for a full disclosure of an offering.

With a statute as new as Internal Revenue Code §6111 and as untested in judicial proceedings, I submit that the courts should be allowed some latitute in imposing penalties. After all, the purpose of that section is to provide the Internal Revenue Service with valid information as to offering with tax shelters ratios in excess of two--to-one, not to flood the IRS Kansas City office with worthless registrations.

Suggested Amendment

Amend Subsection (a)(2), Section 1532 of TRA-86 to read:

(2) AMOUNT OF PENALTY - The penalty imposed under paragraphs (1) with respect to any tax shelter shall not be less than $500 or more than 1 percent of the aggregate amount invested in such tax shelter.

Under such language, the Treasury and the courts would have the authority to "let the punishment fit the crime."

2. Correction to IRC Section 280A(d)(2).

The last sentence of IRC §280A(d)(2) deals with taxpayer use of a dwelling unit for repairs and annual maintenance. Now that TRA-86 requires material participation under its Section 501 (IRC §469), a taxpayer is required to visit the dwelling unit regularly for purposes of participating in its operation. The same rationale ,therefore, now exists to define as not personal use visits which are made for the purpose of participating in the dwelling units operation as those which prompted the Congress to exclude from personal use "use of the unit for repairs and annual maintenance". That rationale is that the taxpayer is using his or her unit not for personal purposes, but for purposes directly related to the trade or business of renting the unit.

Suggested Amendment

This amendment could be accomplished by inserting before the words "repair and annual maintenance" the words "the purpose of material participation in the operation of the unit or for" and by inserting before the words "repair and maintenance" the words "material participation in the operation of the unit or". This amendment would not alter the requirement that the taxpayer be so engaged "on a substantially full time basis for any day" so excluded from personal use.

I submit that both of these amendments are technical in nature. The first one dealing with IRC §6111 does not lessen the maximum penalty adopted in TRA-86. It merely allows the Treasury and the courts some latitute in determining the correct severity. As it stands now, any lawyer who opines on any tax issue must insist on registration regardless of the ratio. If he does not know the ratio, he or she must register, but decline to estimate because of "the penalties of perjury".

The second amendment, that of IRC §280A, is a conforming amendment, conforming the language of IRC §280A to the new requirements of IRC §469.

Thank you for your consideration of these matters.

Very truly yours,

PETER M. GUNNAR, P.C.

Peter M. Gunnar

HARRIS W. FAWELL
13TH DISTRICT, ILLINOIS

EDUCATION AND LABOR
SUBCOMMITTEES:
LABOR-MANAGEMENT RELATIONS
ELEMENTARY, SECONDARY, AND VOCATIONAL EDUCATION

SCIENCE, SPACE, AND TECHNOLOGY
SUBCOMMITTEES:
ENERGY RESEARCH AND DEVELOPMENT
INTERNATIONAL SCIENTIFIC COOPERATION

SELECT COMMITTEE ON AGING

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Washington, DC 20515

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July 17, 1987

The Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
1102 Longworth HOB

Dear Mr. Chairman:

Enclosed please find a copy of recommended technical corrections to the Tax Reform Act of 1986 that I have recently received from Mr. Donald Schiller, President of the Illinois State Bar Association. I strongly recommend your Committee's consideration of this information.

Your cooperation in this regard is highly appreciated.

Very truly yours,

Harris W. Fawell, M.C.
318 House Office Building

Enclosure

OFFICE OF THE PRESIDENT

ISBA
ILLINOIS STATE BAR ASSOCIATION

200 NORTH LaSALLE STREET • SUITE 2700 • CHICAGO, ILLINOIS 60601 • TELEPHONE 312—641-5560

DONALD C. SCHILLER
PRESIDENT

July 9, 1987

Honorable Daniel Rostenkowski
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Rostenkowski:

As President of the Illinois State Bar Association, I am pleased to transmit recommended technical corrections to the Tax Reform Act of 1986. Some may already be reflected in the technical corrections bills now pending in Congress.

Following is a summary of the recommendations which were approved by the Illinois State Bar Association (references to Sections are to the Sections of the Internal Revenue Code of 1986):

1. Compliance

The recommendations related to (a) the determination of the base amount on which to apply the negligence penalty (Section 6653(a)(1)(A)); (b) the standard of care required in preparing information returns (Section 6724(c)(1)); (c) the burden of proving the portion of underpayment of tax which is due to fraud (Section 6653(b)); (d) underpayments due to a mistake of fact (Section 6651); (e) windfall profits tax reporting requirements (Section 6050(c)); and (f) the deductibility of interest on indebtedness secured by condominium owners, land trust beneficiaries, etc. (Section 163(h)).

2. Alternative Minimum Tax

The recommendations relate to (a) the definition of the tax base (Section 56); (b) treatment of capitalized depreciation (Section 56); (c) treatment of intangible drilling costs and the tax preference for excess intangible drilling costs (Sections 56, 57 and 58); (d) treatment of capital loss and charitable contribution carryforwards from pre-1987 taxable years (Section 56); (e) the limitation on the use of investment tax credits (Section 38); (f) the allowance of the regular investment tax credit (Section 38); (g) the exclusion preference (Section 53); (h) the exclusion of recapture tax from the computations of the regular tax (Section 55); (i) the coordination with certain limitations (Section 59); (j) the adjustment for personal exemptions (Section 56); (k) adjustments for interest deductions of individuals (Section 56); (l) the appreciated portion of property contributed to charity by trusts as a tax preference item (Section 67); and (m) miscellaneous technical changes.

3. General Utilities Doctrine and Subchapter S

The recommendations relate to (a) attribution of preferred stock of the loss corporation (Sections 382 and 318); (b) net operating loss deduction when there is an exchange of indebtedness for stock of the loss corporation, or when indebtedness is converted into stock in a bankruptcy proceeding, or when there is accrued but unpaid interest, (Section 382); (c) effective dates for Section 382 changes; (d) nonrecognition of loss when property is distributed to related persons (Section 336); (e) effective dates for Section 382 changes; (f) recognition of losses by a liquidating corporation on distribution to 80% distributees which are foreign corporations or are tax exempt (Section 336); (g) basis of property received in a Section 332(a) distribution by a liquidating corporation (Section 334); (h) use by S corporations of acquired C corporations' net operating losses and capital loss carryforwards (Section 1374); (i) non-recognition of gain by small corporations from installment sales during the transition period (Section 633); and (j) miscellaneous other technical changes.

4. Individual Income Tax Changes and Limitations on Deductibility of Non-Business Interest

The recommendations would (a) exclude as miscellaneous itemized deductions for trusts and estates charitable contributsion and income distributions deductions, (Section 67), and clarify the interaction of the 2% limitation on miscellaneous itemized deductions with other limitations applicable to living expenses for members of Congress and unreimbursed employee meal and entertainment expenses (Section 162); (b) eliminate as a condition to the application of Section 274(e) exceptions to the 80% and other limitations applicable to business meals and luxury water transportation the unrelated requirements of Section 274(a) pertaining to the deduction of entertainment expenses; (c) provide that the presence at business meals of independent contractors performing services for a taxpayer satisfies the presence requirement of Section 274(k), and clarify that reference to "lavish or extravagant" is a limitation on, not a condition to, deductibility; and (d) provide that interest carrying charges described in Section 266 incurred in connection with the acquisition of personal property are to be treated as part of the cost of the acquired property.

5. Qualified Retirement Trusts

The recommendations relate to (a) an alternate approach to Section 401(a)(26); (b) wasting trusts; (c) interest rate and excise taxes; (d) definition of separate plans; (e) sanctions for failing the minimum participation rule; (f) adoption of exemptions for plans with no highly-compensated employees; (g) the impact of Section 415; (h) the preservation of TEFRA and 242(B) elections; and (i) the liquidation of personal service corporations.

6. Estate, Gift and Generation-Skipping Taxes

The recommendations relate to (a) the generation-skipping tax and ways to make it internally consistent and enforceable; (b) the estate tax exclusion (Section 2039); (c) spousal consents to beneficiary designations (Sections 417 and 2503); (d) special use valuation (Section 2032A(b)(2)); and (e) the new excise and estate taxes on excess retirement distributions and accumulations (Section 4981A).

If you require further explanation or information on any of the recommendations herein, please feel free to contact the Chairman of the Illinois State Bar Association Tax Section, David J. Duez, Esq., McDermott, Will & Emory, 111 West Monroe Street, Chicago, Illinois 60603, Telephone A/C 312/984-7544.

Sincerely,

Donald C Schiller

Donald C. Schiller

(Attachment being retained in Committee files.)

STATEMENT OF

THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

ON THE PROPOSED

TECHNICAL CORRECTIONS ACT OF 1987
(H.R. 2636)

INTRODUCTION

My name is Wallace R. Woodbury. I am Chairman of the Board of Woodbury Corporation, Salt Lake City, Utah, a long-established real estate development, brokerage, management and consulting firm. I am also chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and a member of the Board of Trustees. I submit this testimony on the proposed Technical Corrections Act of 1987 (H.R. 2636) on behalf of the members of ICSC.

ICSC is the trade association of the shopping center industry with over 21,000 members. Membership includes developers, owners, retailers, lenders, and others having a professional interest in the shopping center industry. ICSC members represent most of the 28,500 shopping centers in the United States. In 1986, these centers generated $554 billion in retail sales, representing 54% of total retail sales (exclusive of automotive sales). These centers generated $20.3 billion in sales tax revenues and employed 6.9 million people.

STATEMENT

(1) Material Participants in the Real Estate Business

Although the Tax Reform Act of 1986 contained many provisions increasing the taxes paid by the real estate industry, there is one provision which is so discriminatory, so unfair and so central to our business that we must call it to your attention and request that it be corrected at the earliest opportunity. We refer specifically to those parts of the passive loss rules which define all rental income as passive, regardless of the material participation of the taxpayer in producing that income. Shopping center developers are not passive investors looking for tax deductions. They are full-time businessmen and women who, if they were in any other industry, would be allowed to offset losses from one part of their business against all other income. However, material participants in the real estate business cannot offset losses from rental properties against other kinds of income, or even against such real estate related income as management and development fees and commissions. This is a grossly unfair discrimination against one industry -- real estate.

When the tax reform process started, its stated objective was to eliminate distortions in business planning caused by taxes. It is most strange that a discriminatory provision, which singles out recipients of rental income for special onerous treatment, emerged from a reform process dedicated to producing a "level playing field" among taxpayers. The passive loss provisions will have the clear effect of penalizing and discouraging development of and investment in real estate investment -- a distinct tilt to the playing field.

This special rule for material participants in the real estate business works in a particularly harsh manner against the new developer trying to enter the business and will work to reduce competition with all the attendant unwholesome effects of such a result. The rule means that a new entrant must finance his new projects, which typically have losses in the early years, with after-tax dollars, while entrepreneurs in all other fields can use pre-tax dollars.

For example, assume a taxpayer owns and manages a clothing store and a restaurant. Both produce active income or loss, and a loss from one of these stores can offset income from the other. If both stores show a net loss, he can offset this loss against portfolio or other income.

Compare this with a taxpayer in the real estate business. He has losses from rental properties and management fees from other properties, a not uncommon situation. Even though this is all part of his real estate business, the 1986 tax act does not permit the losses from rents (passive losses) to offset the income from the management fees (active income). This is true even if the rental losses are real, out-of-pocket losses, i.e., the loss is greater than the depreciation deductions.

The passive loss rules were intended to restrict truly passive investors from offsetting rental losses against salary and professional income. We are not objecting to that result. Although we do not think it was necessary to go as far as the Tax Reform Act of 1986 did to achieve this result, we consider the elimination of the tax-abusive real estate transactions to be salutary. However, we object to the classification of the real estate related income of full-time, active real estate developers as "passive," particularly when material participants in all other businesses are allowed to offset all their income and losses.

When Congress voted on the 1986 tax act, it did not have the opportunity to vote on particular provisions separately. We believe that many Members of the House and Senate were disturbed by the unfairness of this provision. Accordingly, the passive loss rules should be amended to provide for a material participant exception for real estate at the earliest opportunity.

(2) Installment Sales

ICSC supports the provisions of the proposed Act in section 108(f) which clarify the application of the new rules to pre-1987 installment sales transactions. The bill would clarify that payments received after January 1, 1987 would be categorized as active or passive as required by the new law. This provides a desirable consistency in treatment of such payments.

However, ICSC believes a better solution to the installment sales issue is that contained in H.R. 587 which restores the pre-1987 installment sales rules for non-dealers. The Tax Reform Act of 1986 limits the use of the installment sales method by treating as a payment in the year of the sale an imputed amount equal to the face amount of the installment obligation multiplied by the ratio of the taxpayer's total debts (broadly defined) to his total assets (the adjusted basis of his assets plus the amount of all installment obligations).

This calculation requires data on both debts and asset values that is not required for any other tax or business purpose. Therefore, this information is not readily available in taxpayers' records for either the taxpayer's determination of the tax or a revenue agent's review on audit, thus creating difficult compliance and enforcement problems.

The present "proportional disallowance" rule law is unfair and not supported by sound tax policy grounds. It makes the unwarranted assumption that there is some nexus between all of the taxpayer's debt and his installment obligations. In the case of real estate investments, each project is financed to stand alone. It is improper for the tax code to consider totally extraneous investments in order to impute, as cash received, an artificial amount equal to the ratio of total debt, including unrelated debt, to book value of total assets, including unrelated assets. This is not a situation where the purchase money note or the underlying property is used as security for a separate loan.

The practical effect of the installment sales provision is to discourage its use in the real estate business. This constitutes an unnecessary restriction on business financing and is unnecessary to correct any perceived abuse in the tax law. This is especially true in view of the fact that the use of the installment method provides only a deferral of tax, not an escape from tax, for the period when there is insufficient cash to pay the tax. The tax policy consideration that a tax should be assessed only when cash is available from a transaction to pay the tax is sound and should be reinstated. It is additionally justified in the case of the installment method because the seller may never receive the payments provided by the obligation. For example, payments under an installment sales agreement may never be made if the buyer becomes insolvent, although the seller has paid taxes based on the "proportional disallowance" rule.

We appreciate the opportunity for submitting these comments and hope they are of use to you.

LAFAYETTE COLLEGE

Office of the President

June 29, 1987

COMMITTEE ON
RECEIVED
JUL 2 1987
WAYS AND MEANS

Dear Chief Counsel:

I write to express concern with respect to two aspects of the Tax Reform Act of 1986. Lafayette College for sometime has attempted with some success to raise funds through charitable gift annuities. It is my understanding that the recently passed Tax Reform Act, wherein it addressed itself to insurance activities of non-profit organizations (TIAA may have been in mind), included wording which drew into question whether charitable gift annuities would become subject to unrelated business tax.

Charitable gift annuities are a very imporant source of funds for non-profit institutions, especially colleges and universities, and current confusion on this matter is very detrimental. I write in the hope that there can be clarification of this matter and that charitable gift annuities will not be treated as an unrelated business by colleges and univesities.

I also write on a second point. Many colleges and universities, including Lafayette College, have early retirement plans. Our plan makes provision for tenured faculty who retire early to receive payments over a period of five years, in part in return for giving up their tenured position. These payments are not bonuses and they are not particularly great. Over the last three years, most of the payments have been in the vicinity of 30% of salary. It is my understanding that under the new Tax Reform Act, Section 457, as interpreted by the IRS, such a plan would be considered to be deferred compensation to the individual and that the recipient would be immediately responsible for tax on the full amount. I would like to encourage Congress to clarify this point in the direction that early retirement plans, which are used for tenured faculty, be non-taxable as deferred compensation but rather taxable upon receipt which was the understanding prior to the ruling of the Internal Revenue Service.

Thank you for your help on these matters; they are both of substantial import to colleges and universities in this country. If I could provide any additional information, I would be pleased to do so.

Sincerely,

David W. Ellis

David W. Ellis

The Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Wasington, D.C. 20515

Easton, Pennsylvania 18042

WILMER, CUTLER & PICKERING
2445 M STREET, N. W.
WASHINGTON, D. C. 20037-1420

July 17, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Comments Suggesting Clarification of the Ordering Rule for Using Components of the General Business Credit and Requesting Clarification of Section 107(g)(2) of the Technical Corrections Act of 1987 (H.R. 2636)

Dear Sir:

These comments respond to the request, contained in the June 10, 1987 press release of the Committee on Ways and Means,[1] for comments on the Technical Corrections Act of 1987 (H.R. 2636).

These comments request (1) confirmation that the components of the general business credit are to be utilized in the order in which they are listed in section 38(b) of the Internal Revenue Code of 1986 (the "Code"), (2) confirmation that subcomponents of the investment credit generally are utilized in the order set forth in section 46(a), (3) clarification that the reduction of regular investment credit carryforwards under section 49(c) of the Code shall proportionately reduce the credits carried forward from each year, and (4) clarification that section 107(g)(2) of H.R. 2636 expands the allowable general business credit for C corporations but does not provide an ordering rule for the utilization of the credit.

A. Clarification of the Ordering Rule for Components of the General Business Credit

When Congress amended the general business credit provisions in DEFRA by making the investment credit, the targeted jobs credit, the alcohol fuels credit, and the PAYSOP credit part of the section 38(b) general business credit, it failed to provide an explicit ordering rule for use of the components of the general business credit. That failure continued in the 1986 Act.

Moreover, the Treasury Department has not issued regulations or published rulings that address the issue of the ordering of the components of the general business credit.

The ordering rules of present law need clarification. The most appropriate ordering rule is that the components should be utilized in the order listed in section 38(b) - first the investment credit determined under section 46(a), then the targeted jobs credit, etc. However whether that rule is in force under existing law is in doubt because section 38(d) adopts precisely that ordering rule as a "special rule" for regulated public utilities. Ostensibly, the special rule would not have been needed if a general rule provided the same result.

Section 49(c)(5)(C) further confuses the issue. Section 49(c)(1) provides for a 35-percent reduction in any portion of the business credit carryforward under section 38(a)(1) attributable to the regular investment credit which has not expired as of the close of the taxable year preceding the first taxable year of the taxpayer beginning after June 30, 1987. Section 49(c)(5)(C) specifies that

> the portion of any current year business credit or business credit carryforward which is attributable to the regular investment credit shall be determined on the basis that the regular investment credit is used first.

It is not clear how this rule interrelates with whatever ordering rule is mandated by section 38. For example, does section 49(c)(5)(C) mean that regular investment credit from 1985 would be used before targeted jobs tax credit from 1984? Or does the normal rule continue to apply that, in a carryforward year, carryforwards to that year are first claimed on a FIFO basis, then the business credit earned in that year is claimed? We understand from informal conversations with Joint Committee staff that the latter interpretation was intended. However, the meaning of the provision should be clarified.

The problem with not having an explicit and unambigious ordering rule is that taxpayers are left without guidance on important issues in filing their tax returns. For example, although the Conference Committee recognized that carryforwards of the investment-based employee stock ownership credit (or "TRASOP credit") are still available as part of the investment credit component of the general business credit (even though investments after 1982 could not qualify for additional TRASOP credits),[1] it gave no guidance as to the order in which the investment credit component of the general business credit (or any subcomponents) would be utilized. This is an important question for taxpayers attempting to determine the proper year for funding their TRASOPs because the TRASOP must be funded in the year in which the credit is utilized.[2]

We believe that in order to provide fair guidance to taxpayers, three changes should be made to the ordering rules. First, a general ordering rule should be set forth for components of the general business credit to the effect that credits should be used in the order in which they are listed in section 38(b). This rule would be consistent with the rule endorsed in the Senate Finance Committee Report.[3]

---

[1] "Thus, for example, 100 percent of ITC carryovers may continue to be allowed for funding an investment tax credit employee stock ownership plan." H.R. Conf. Rpt. No. 841, 99th Cong., 2d Sess. at II-64 (1986).

[2] See Section 48(n)(1) of the Internal Revenue Code of 1954, before that subsection's repeal in DEFRA: The TRASOP credit "shall not apply . . . unless the taxpayer on his return for such taxable year agrees . . . to make transfers of employer securities to a [TRASOP] . . ., to the extent allocable to that portion of the [TRASOP] credit which is allowed as a carryover in a succeeding taxable year, not later than 30 days after the due date (including extensions) for filing the return for such succeeding year."

[3] See the Senate Finance Committee's description of the reduction of ITC carryforwards in which it stated that --

> [i]f a regular investment tax credit is allowable for a taxable year beginning after December 31, 1986, the amount allowable is reduced by 30 percent (15 percent, in the case of credits allowable for a taxable year beginning in 1987). . . . For purposes of determining the extent to which an investment credit determined under section 46 is used in a taxable year beginning after December 31, 1986, the order in which other credits included in a taxpayer's general business credit are used shall be determined on the basis of the order in which they are listed in section 38(b).

S. Rpt. No. 313, 99th Cong., 2d Sess. 115 (1986).

Second, the Code should provide that subcomponents of the investment credit are utilized in the order set forth in section 46(a). This rule would be consistent with present IRS ruling practice.[4]

The foregoing amendments could be achieved by amending section 38(d) of the Code to make it generally applicable rather than restricting its application to certain regulated companies. Preferably the amendment would be treated as a DEFRA technical correction so that the guidance would apply retroactively to the point at which the old ordering rules were repealed.

The statute should also provide for the situation where a component of the general business credit or a subcomponent of the investment credit is deleted from the statute or its order in the statute is changed.[5] Generally, order should be determined by the order in the statute at the time the carryover is used or, in the case of a subcomponent of the investment credit which is no longer listed, in the order in which that subcomponent appeared when the property was placed in service or the credit was otherwise earned. If the statute no longer references a component at the time of use, it should be utilized after the components listed in section 38(b).[6]

As amended, section 38(d) would provide --

> ORDERING RULES.--In the case of any taxpayer, for purposes of sections 46(f), 47(a), 196(a) and any other provision of this title where it is necessary to ascertain the extent to which the credits determined under sections 40(a), 41(a), 42(a), 46(a), or 51(a)

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[4] *See* LTR 8645044 (August 11, 1986).

[5] Alternatively, the statute could provide a summary table setting forth the ordering which result from the rules we propose for section 38(d).

[6] This problem arises, for example, with PAYSOP credits or WIN credits carried to 1987. Carryforwards of WIN credits enter the issue of utilization of the general business credits because section 39(d) of the Code made unexpired pre-DEFRA carryforwards a general business credit carryforward.

Although we cannot think of a situation in which this would occur, we suggest that if the taxpayer has more than one component from a given year which is no longer referenced, it would utilize those components in the order in which they would have been utilized in the year from which they were carried but after it utilized the listed components of section 38(b).

> and section 41(a) of the Internal Revenue Code of 1954 (as in effect on the day before the enactment of the Internal Revenue Code of 1986) and carryforwards under section 39(d)(1) of the Code are used in a taxable year or as a carryback or carryforward, the order in which such credits are used shall be determined on the basis of the order in which they are listed in subsection (b) and, in the case of the investment credit, in the order in which the subcomponents of the investment credit are listed in section 46(a) (or were listed in the year in which the property was placed in service or the credit was otherwise earned). For purposes of this subsection, order should be determined by the order in subsection (b) at the time the carryover is utilized. Components of the general business credit that are not listed in subsection (b) shall be utilized, after the listed components, in the order in which they would be have been utilized in the year from which they were carried forward.

Third, section 49(c)(5)(C) should be amended so that it cross-references the general rule and clarifies that the 35-percent reduction is applied proportionately against the regular investment tax credits carried to 1987:

> (C) Portion of Credits Attributable to Regular Investment Credit. -- The portion of any current year business credit or business credit carryforward which is attributable to the regular investment credit shall be determined under subsection (d) of section 38. The amount of the reduction of the regular investment credit carryforward under this subsection shall be deemed to reduce the regular investment credit carryforwards from a given taxable year in proportion to the ratio of that year's regular investment credit carryforwards to the total carryforwards reduced under this subsection.

For example, a calendar year taxpayer places property in service in 1984 and 1985 and claims regular investment credits of $2 and $10 for those years. It carries the credits forward to 1987. Pursuant to section 49(c)(3), it reduces the $12 of regular investment credits by $2.10 (17.5 percent of $12). It then reduces its 1984 carryforward by $0.35 ($2.10 times $2/$12) and its 1985 carryforward by $1.75 ($2.10 times $10/$12).

The manner in which the ordering rules should work under the clarifying amendments suggested above can be illustrated by the following example:

> A calendar year taxpayer earns the following credits in 1982: $100 of regular investment tax credit, $10 of TRASOP credits, and $10 of research credits. It carries the credits forward to 1987 in which year it earns $10 of regular investment tax credits from transition property and $10 of research credits. In the first instance, the 1987 transition regular investment tax credit is reduced by 17.5 percent to $8.25 and the 1982 regular investment tax carryforward is reduced by 17.5 percent to $82.50. Because of the application of the 75% limitation on general business tax credits, assume further that only $90 of the credit is used in 1987. This $90 will be utilized in the following order: $82.50 of 1982 regular investment tax credits and $7.50 of TRASOP credits.[7] The taxpayer will fund its TRASOP with a contribution reflecting the $7.50 of credit utilized in 1987.
>
> The taxpayer will carry forward $30.75 to 1988, plus a gross up equal to $1.75 (the adjustment provided under section 49(c)(4)(B)(ii), using the language of H.R. 2636). The $8.25 of 1987 regular investment tax credit and the $1.75 of gross up credit are added together and then reduced by 35 percent to $6.50. Because of the 75% limitation on general business tax credits, assume that only $25 of the credit may be used in 1988. The total carryforward that could be utilized in 1988 will be $25 utilized in the following order: $2.50 of 1982 TRASOP credit, $10 of 1982 research credit, $6.50 of 1987 regular investment tax credit, and $6 of 1987 research credits, leaving $4 of 1987 research credits to be carried forward to 1989.

B. Revision of Section 107(g)(2) of H.R. 2636

The Committee should also revise section 107(g)(2) to clarify that the ordering rule for purposes of determining the amount of the allowable credit is not the ordering rule for utilization. The technical correction in its present form could be read to reverse the customary ordering in using the components of the general business credit: allowing use of the regular investment tax credit only after use of the other components of the general business credit.

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[7] Because the research credit is listed in section 38(b) for 1987, it is utilized in the order shown in that subsection. Because the TRASOP is no longer listed, it is utilized in the order which existed when the property with respect to which the TRASOP credit is earned was placed in service.

1. General Business Credit Limitation Under Section 38(c) of the 1986 Code

Section 38(c)(1) of the Code provides the general limitation on the utilization of the general business credit under section 38(a). Before enactment of the Tax Reform Act of 1986, a corporate taxpayer could offset its regular income tax, but not its minimum tax, with the general business credit. Section 38(c)(1) of the Code retained that general rule by limiting the allowable general business credit to the lesser of (1) the sum of (A) so much of the net regular tax liability as does not exceed $25,000 and (B) 75 percent of so much of the net regular tax liability as exceeds $25,000 and (2) the excess of the net regular tax liability over the tentative minimum tax for the year.

Congress enacted a special limitation for C corporations, permitting them to make greater use of the general business credit.[8] It added paragraph (3) to section 38(c) to provide that a C corporation could use its regular investment tax credits to offset a portion of its tentative minimum tax if it would otherwise be subject to the minimum tax.[9]

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[8] The staff of the Joint Committee on Taxation explained that "[i]n order to provide transition relief, corporations are permitted to use regular investment tax credits to offset up to 25 percent of minimum tax liability." 1986 Bluebook at 437-38.

[9] The 1986 Act did not make clear the interrelationship between the (c)(1) limitation and the new provision in (c)(3). Although it seems clear that section 38(c)(3) was intended to permit C corporations to use an additional portion of its general business credits, the lack of a cross reference to section 38(c)(1) left open the possibility that (c)(3) could be misread to be an alternative to (c)(1), rather than a supplement. Section 107(g)(2) of H.R. 2636 makes clear that C corporations may utilize an additional portion of its general business credits. But in making this commendable clarification, H.R. 2636 raises new problems discussed herein.

2. Section 107(g)(2) of H.R. 2636

H.R. 2636 could be read to permit use of the regular investment tax credit to offset corporate minimum taxes only if the other components of the general business credit are first exhausted. The accompanying Joint Committee description of this provision says only that the computation of the allowable limit will be made as if the other components were used before the regular investment tax credit:

> Investment tax credits.--The bill clarifies that the total amount of the general business credit allowable to a C corporation for a taxable year in which the regular tax exceeds the tentative minimum tax is determined as if any portion of the general business credit not attributable to the regular investment tax credit first offset the regular tax, and the regular investment credits (to the extent otherwise available) then reduced the net tax to 75 percent of the tentative minimum tax.[10]

We suggest that the Committee clarify that the proposed amended section 38(c)(3) is used to determine the amount of the allowable general business credit for purposes of section 38(c) and does not address the order in which C corporations in fact utilize those credits. The ordering in section 107(g)(2) appropriately implements Congressional intent to expand the allowed general business credit for C corporations, but if the technical correction were deemed to specify the order for utilization, it would be inconsistent with what appears to be the correct rule: namely, that components of the general business credit generally should be utilized in the order listed in section 38(b). Under that order, the investment credit, of which the regular investment credit is a subcomponent would be utilized first.

Sincerely,

F David Lake, J

F. David Lake, Jr.

R Scott Kilgore

R. Scott Kilgore

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[10] Staff of the Joint Committee on Taxation, Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) at 63 (June 15, 1987).

APPENDIX

GENERAL BUSINESS CREDIT LIMITATION EXAMPLES
(Dollars in Millions)

Example 1

Credits earned & carried forward to 1985:

	1981	1982	1983	1984	1985	Total
Regular ITC	29	18	16	14	10	87
TRASOP 1%	3	2	0	0	0	5
TJTC	1	1	1	1	1	5
Research	10	8	7	6	5	36
Win Credit	4	0	0	0	0	4
PAYSOP	0	0	2	3	4	9
Total	47	29	26	24	20	146

1985 tax liability	76
Credits allowed:	
Research	36
General business credit	34
Total credits allowed	70
Net tax	6

Notes:

1) In 1985 the research credit was not part of the general business credit; it had its own limitation.

2) The $34 of general business credit is made up of full $29 of 1981 regular ITC, the $3 of 1981 TRASOP credit, the $1 of 1981 Targeted Jobs Tax Credit, and $1 of 1981 WIN credit. The TRASOP credit is used in the order in which it appeared in section 46(a) when the property with respect to which it is claimed was placed in service. Since the WIN credit is not listed in section 38(b), it is used after all the listed credits.

Example 2

Credits earned & carried forward to 1985:

	1981	1982	1983	1984	1985	Total
Regular ITC	10	21	16	14	10	71
TRASOP 1%	1	2	0	0	0	3
TJTC	1	1	1	1	1	5
Research	10	8	7	6	5	36
PAYSOP	0	0	2	3	4	9
Total	22	32	26	24	20	124

1985 tax liability	76
Credits allowed:	
Research	36
General business credit	34
Total credits allowed	70
Net tax	6

Notes:

1) In 1985 the research credit was not part of the general business credit; it had its own limitation.

2) The $34 of general business credit is made up of the full $12 of 1981 credit, the full $21 of 1982 regular ITC, and $1 of 1982 TRASOP credit. The other $1 of 1982 TRASOP credit, the $1 of 1982 TJTC and the full general business credits from 1983-1985 remain as carryovers.

Example 3

Credits earned & carried forward to 1987:

	1981	1982	1983	1984	1985	1986	1987	Total
Regular ITC	20	18	16	14	10	4	2	84
Reduced ITC	17	15	13	12	8	3	2	70
TRASOP 1%	2	2	0	0	0	0	0	4
TJTC	1	1	1	1	1	1	1	7
Research	10	8	7	6	5	7	10	53
PAYSOP	0	0	2	3	4	0	0	9
Total	30	26	23	22	18	11	13	143

1987 regular tax liability	200
1987 tentative minimum tax	104
Section 38(c)(1) limitation	
(1) Sec. 38(c)(1)(A) limitation	150
(2) Sec. 38(c)(1)(B) limitation	96
(3) Sec. 38(c)(1) limitation (lesser of (1) or (2))	96
Section 38(c)(3) addition	
(4) Regular ITC (17.5% reduction)	70
(5) Sec. 38(c)(1) limitation (line (3))	96
(6) General Business credit available other than regular ITC	73
(7) Line (5) less line (6)	23
(8) Line (4) less line (7)	47
(9) 25% of 1987 tentative minimum tax	26
(10) Sec. 38(c)(3)(A) addition (lesser of (8) or (9))	26
Revised section 38(c)(1) limitation	
(11) Revised Sec. 38(c)(1)(B) limitation (line (2) + line (10))	122
(12) Revised Sec. 38(c)(1) limitation (lesser of (1) or (11))	122
Regular tax liability	200
General business credit	122
Net tax	78

Notes:

1) Taxpayer is a calendar-year taxpayer.
2) The calculation of the credit limitation uses the proposed rules of H.R. 2636.
3) The $122 credit is made up of the full $30 of 1981 credit, the full $26 of 1982 credit, the full $23 of 1983 credit, the full $22 of 1984 credit, the full $18 of 1985 credit, and the full $3 of 1986 regular ITC. These numbers reflect the 17.5% reduction for regular ITC for each year.
4) The carryover to 1988 would be made up of $1 of 1986 TJTC, $7 of 1986 research credit and the full $13 of 1987 credit. (The reduction of 1987 regular ITC is lost in the rounding.)

Example 4

Credits earned & carried forward to 1987:

	1981	1982	1983	1984	1985	1986	1987	Total
Regular ITC	23	18	25	14	10	4	3	97
Reduced ITC	19	15	21	12	8	3	2	80
TRASOP 1%	2	2	0	0	0	0	0	4
TJTC	1	1	1	1	1	1	1	7
Research	6	3	4	3	2	2	1	21
Win Credit	4	0	0	0	0	0	0	4
PAYSOP	0	0	4	3	4	0	0	11
Total	32	21	30	19	15	6	4	127

1987 regular tax liability	160
1987 tentative minimum tax	104
Section 38(c)(1) limitation	
(1) Sec. 38(c)(1)(A) limitation	120
(2) Sec. 38(c)(1)(B) limitation	56
(3) Sec. 38(c)(1) limitation (lesser of (1) or (2))	56
Section 38(c)(3) addition	
(4) Regular ITC (17.5% reduction)	80
(5) Sec. 38(c)(1) limitation (line (3))	56
(6) General Business credit available other than regular ITC	47
(7) Line (5) less line (6)	9
(8) Line (4) less line (7)	71
(9) 25% of 1987 tentative minimum tax	26
(10) Sec. 38(c)(3)(A) addition (lesser of (8) or (9))	26
Revised section 38(c)(1) limitation	
(11) Revised Sec. 38(c)(1)(B) limitation (line (2) + line (10))	82
(12) Revised Sec. 38(c)(1) limitation (lesser of (1) or (11))	82
Regular tax liability	160
General business credit	82
Net tax	78

Notes:

1) Taxpayer is a calendar-year taxpayer.
2) The calculation of the credit limitation uses the proposed rules of H.R. 2636.
3) The $82 credit is made up of the full $32 from 1981, the full $21 from 1982, and $29 from 1983. The $29 from 1983 is used in the following order: first, the full $21 of regular ITC; second, the full $1 of TJTC; third, the full $4 of research credit; and fourth, $3 of the $4 of PAYSOP credit. Since the PAYSOP credit is not listed in section 38(b) in 1987, it is used after the credits which are listed. The ITC used reflects the 17.5% reduction for each year.

July 17, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

The National Association of Home Builders (NAHB) appreciates this opportunity to present its comments on the Technical Corrections Act of 1987 (H.R.2636).

First, we would like to note that several positive provisions are contained in H.R. 2636. These include the following items:

o Clarification that income received after 1986 from installment sales of passive activities before 1987 can be used to offset passive activity losses;

o The treatment of interest on indebtedness secured by a qualified residence and incurred after August 16, 1986, to refinance grandfathered indebtedness as qualified residence interest;

o Several changes designed to make the low-income housing tax credit more workable; and

o Disallowance of a separate fee to be charged in connection with the real estate transaction information reporting requirements.

These, and other changes proposed in H.R.2636, will provide for a smoother transition to the new tax law. However, there are several other concerns that NAHB feels should be addressed. Admittedly, some of these concerns may be considered to go beyond the scope of technical corrections. However, they are in urgent need of being addressed legislatively. NAHB's concerns are described below:

Contributions in aid of construction

One of the major problems confronting home builders as a result of the Tax Reform Act of 1986 is the taxation of contributions in aid of construction (CIAC). Prior to the 1986 Tax Act, CIAC was not treated as taxable income to the recipient utility company. Rather, CIAC was treated as a nontaxable contribution to capital. The builder making the contribution could not deduct the payment made to the utility company. Likewise, the utility company could not depreciate any property it received.

As a result of the 1986 Tax Act, investor-owned utility companies now must include CIAC in income. The additional cost that results from taxing CIAC, basically, can be handled in two ways. The cost can be passed on to the builder, or the cost can be passed on to the utility's customers in the form of higher rates. Our experience has been that, at least initially, the cost is being passed on to the builder. In general, [illegible] companies have been "grossing up" their additional tax costs to builders. Assuming a 40 percent Federal income tax rate for the utility company, this amounts to a 67 percent cost increase for the builder. Thus, by and large, builders are not only making contributions to utility companies, they are also paying the tax on the contributions. In order for the builders to come out whole, they must increase the price of the homes they are selling, thus forcing many would-be home buyers out of the market. Many builders must cut back new home construction drastically because they do not have the means to come up with the funds necessary for paying the tax incident to CIAC. Of course, in areas that are served both by investor-owned utilities and governmentally-owned utilities, builders can avoid the problem by taking their business to governmentally-owned utilities, which are not taxed. However, this puts the investor-owned utilities at a competitive disadvantage.

NAHB believes that the only fair way to resolve this problem is to restore prior law. However, short of such action, there are several technical corrections that can be made to mitigate the results somewhat. For example, Congress could clarify that relocation expenses (e.g., the movement of a water main from one location to another) are not CIAC. Furthermore, it could be provided that where the tax is "grossed up" to the builder, the gross up should take into account the present value of depreciation deductions with respect to the contributed property (or the property purchased with contributed money). Finally, the contribution could be treated as an ordinary and necessary business expense deductible in the year of the contribution. This would be only logical since the contribution is treated as taxable fully in the year of receipt.

Tax-credit for low-income rental housing

NAHB believes that the tax-credit for low-income rental housing was one of the highlights of last year's tax reform effort. Although the final product was far from perfect, the enactment of the credit at least indicated Congress' belief that a tax incentive must be provided to encourage construction, rehabilitation, and maintenance of low-income housing. H.R. 2636 contains several changes designed to make the low-income housing tax credit more workable, but several more changes need to be made.

A major problem with the low-income housing tax credit is that the median income levels in many low-income rural areas are so low that owners of housing projects who want to utilize the tax credit are finding such projects to be economically unfeasible. This problem is caused by the fact that a project's rents are tied to area median gross income. This problem could be resolved by allowing the use of the higher of statewide or area median gross income. This is the same criteria used for determining income eligibility under the mortgage revenue bond program.

The bill would permit carry-forwards of low-income housing tax credit allocations to the succeeding taxable year if the Secretary of the Treasury determines that it was reasonable to believe that the building would be placed in service during the allocation calendar year and that the delay was caused by unforeseen conditions which were not within the control of the taxpayer. We believe that this standard is too vague. Thus, we recommend that the bill's carryover provisions be expanded to provide a safe harbor for projects receiving allocations of low-income housing tax credits for years after 1987 where at least 50 percent of the total building costs have been expended by the end of the allocation year and the project is placed in service no later than the close of the subsequent calendar year.

Low-income housing projects that have been placed in service within the preceding ten-year period are not eligible for the four percent credit for acquisition costs. However, the Code provides an exception for certain Federally-assisted projects if a waiver is necessary to avoid an assignment of the mortgage to

HUD or the Farmers Home Administration or to prevent a claim against a federal mortgage insurance fund or "by reason of other circumstances of financial distress." The bill deletes the quoted language. We urge that the statute be broadened in three ways: First, waivers should be permitted for all distressed Federally-assisted and Federally-insured projects. Second, the bill should provide that waivers will be available upon the certification of HUD or FmHA in the case of Federally-insured or Federally-assisted projects, or of a comparable state or local agency in the case of Federally-assisted, state-or local-financed projects. Third, the bill should maintain the present Code allowance of waivers for reasons of financial distress and expand the authority to grant waivers if necessary to preserve low-income rental housing.

The Code provides for recapture of low-income housing tax credits taken in prior years if an investor disposes of his or her interest in a low-income housing project. A special rule is provided for partnerships consisting of 35 or more partners, under which the partnership may elect to be treated as the taxpayer for purposes of recapture as long as no more than 50 percent of the interests, calculated by value, are transferred within any 12-month period. The bill would limit this special rule to partnerships in which more than 1/2 the capital interests, and more than 1/2 the profit interests, are owned by a group of 35 or more partners each of whom is a natural person or estate. Basing qualifications for this special rule on an ongoing specified percentage of ownership by individuals, as opposed to corporations, would require large public partnership's to calculate continuously their percentages of corporate and individual ownership and would impose needless additional record-keeping burdens. We suggest that the bill be amended to provide that the percentage ownership interests need be met only at the time the partnership makes the election to be treated as the taxpayer. With respect to the availability of the election for investment partnerships in two-tier arrangements, the bill should specify that the election may be made by a partnership that holds a majority interest, directly, or through another entity, in a qualified low-income housing project.

There are special provisions in the low-income housing tax credit that facilitate the development of projects targeted to very low-income tenants (at or below 40 percent of area median income). To qualify, at least 15 percent of the low-income units must be rented to very low-income tenants and gross rents on the market rate units must be at least three times gross rents on the low-income units (the "three to one ratio"). The bill clarifies that for purposes of determining whether a project complies with the gross rent limitation applicable to the low-income housing tax credit, Section 8 housing assistance payments are not counted. However, for purposes of determining whether the three to one rent ratio is satisfied, such rental assistance payments are counted. Thus, Section 8 and similarly assisted projects are effectively precluded from qualifying under the deep rent skewing provision because with such assistance payments, the market rents will not be three times the low income rents. Accordingly, the bill should be amended to make the treatment of Section 8 and similar rental assistance payments consistent in the deep rent skewing provisions. That is, such payments should be disregarded for purposes of determining whether the three to one ratio is satisfied.

The Code provides that the eligible basis of any building for the entire 15-year compliance period is determined on the date the building is placed in service. This provision creates a [illegible] problem [illegible] expenditures are incurred by an owner of a newly constructed building after a project is opened for occupancy. The bill should specify that the eligible basis of a building is determined at the time that the building's qualified basis is determined. Qualified basis is determined on the last day of the taxable year in which the building is placed in service, or if the taxpayer elects, on the last day of the succeeding taxable year.

In order to utilize the low-income housing tax credit with existing housing, the building must be acquired. A problem arises when prospective purchasers want to purchase the partnership interests of a partnership owning an otherwise qualified building instead of buying the building itself. This problem regarding the acquisition credit can be cured by providing that either a building or not less than 90 percent of the interests of the partnership owning the building could be acquired.

The base, against which the amount of the low-income housing tax credit is calculated, is reduced by the amount of the nonqualified nonrecourse financing outstanding with respect to the property at the end of the taxable year. In general, nonrecourse financing is nonqualified if the property was acquired from a related person. It is not uncommon for the owner of a project to have also been the builder. If the builder owned more than a 10 percent interest in the property, and the property was financed with nonrecourse financing, the nonrecourse financing would be nonqualified. The bill should be amended by eliminating the requirement that the property be acquired from an unrelated person for purposes of determining the credit base for the low-income housing credit.

Passive loss rules

The passive loss rules generally do not apply to a taxpayer when he or she is a material participant in the activity. However, for purposes of the passive loss rules, rental real estate is deemed to be a passive activity. Deeming rental real estate to be a passive activity means that, with the limited exception provided for active participants in rental real estate, even those who are material participants in the activity are subject to the passive activity loss limitation. This is patently inequitable. NAHB is not urging that passive investors should have unlimited benefits through investment in rental real estate. Rather, we are merely urging that those who are material participants in the rental real estate business should be treated the same as those who are material participants in any other trade or business activity. Thus, a taxpayer who materially participates in rental real estate should not be subject to the passive activity loss limitation. Admittedly, to make the passive activity loss rules fair for rental real estate would take more than a technical correction. However, we urge you, as soon as possible, to make changes to the passive loss rules that do not treat rental real estate in an arbitrarily unfair matter.

The Tax Reform Act of 1986 contains necessary transition relief for certain low-income housing activities. In general, losses from certain investments made after 1983 and before 1987 are "grandfathered" from the passive activity loss restrictions for a period of up to seven years from the date of the taxpayer's original investment. We urge that this transition rule be broadened slightly. Specifically, the transition rule for low-income housing should be amended to provide that low-income housing placed in service between January 1, 1984 and December 31, 1986 is grandfathered for a period of seven years from the date of the taxpayer's original investment if such low-income housing, or any interest therein, is acquired or purchased by December 31, 1987. This change is necessary because many low-income housing projects that were placed in service last year were unable to be syndicated due to the tremendous uncertainty caused by the tax reform process. We also suggest that the transition relief be available to investors without regard to whether they are required to make payments after December 31, 1986, of 50 percent or more of their obligated investment. This is an arbitrary requirement that discrimates against investors who paid in their contributions early.

Personal interest limitation

The Tax Reform Act of 1986 eliminated deductions for personal interest expenses. However, qualified residence interest remains deductible. We propose that the definition of qualified residence interest be expanded to include interest paid or incurred in connection with the purchase of land upon which the taxpayer intends to construct a principal residence. Moreover, interest on a loan to construct a personal residence should be deductible. Under present law, a taxpayer who has purchased land to construct a home is at a serious disadvantage because he has no qualified residence against which to secure a loan. Thus, we urge you to make this correction.

National Association of Wheat Growers
415 Second Street, N.E., Suite 300, Washington, D.C. 20002, (202) 547-7800

June 30, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The National Association of Wheat Growers would like to take this opportunity to comment on the 1986 tax act and pending technical corrections legislation.

The retroactive repeal of the investment tax credit enacted by the 1986 tax act was of particular concern to the wheat industry. Farming is a capital intensive industry, and the ITC has encouraged production efficiency in agriculture which has been essential in maintaining competitiveness in overseas markets. Capital improvements under tax reform will be more costly, significantly penalizing an already weakened industry.

In addition, because of record low income over the past two years, grain farmers have accumulated large amounts of unused investment credits, which have been discounted by 35 percent in the tax act. Farmers have therefore been penalized to a greater extent than more profitable industries, with only very limited relief provided in the tax act.

The NAWG strongly endorses legislation introduced by Congressman Hal Daub, H.R. 2228, which exempts certain farmers from subsection (c) of section 49 of the Internal Revenue Code of 1986 relating to termination of regular percentage of investment credit carryforwards. The legislation limits eligibility for the exemption to credits earned on property primarily used in the business of farming and to taxpayers who, during the preceding three years, have derived 50 percent of more of their gross income from the trade or business of farming. We believe this provision of H.R. 2228 should be included in H.R. 2636, technical corrections to the 1986 tax act.

Further, we believe the limited investment credit refund for farmers should be broadened to allow a 50 percent cash-out of all unused credits, limited to $2,000 per farmer per year, with any excess credits carried forward at full value. Eligibility requirements would be the same as those for the carryforward exemption.

And, as a partial offset to the ITC repeal, we believe the expensing limitation for capital investments for small business should be expanded. The ITC repeal has not resulted in lower retail prices for farm machinery and equipment, and a larger deduction for the year in which equipment is purchased would be helpful.

A second area of weakness in the tax reform law relates to the elimination of the income averaging election for taxpayers with volatile incomes, like farmers. The NAWG promoted efforts last year to retain income averaging for farmers, and urges the Congress to reconsider this issue in pending technical revisions. The Daub Bill, and numerous other bills introduced in the 100th Congress, recognize the inequity of the income averaging repeal and would restore the income averaging election for farmers.

The Daub Bill also addresses several farmer concerns which are substantially technical in nature. These include the simplification of preference items for passive investments in farming, whereby the separate preference item for "losses from passive farming activities" would be repealed on order not to duplicate the general preference item "net loss from passive trade or business activities". A separate passive loss provision in the Daub Bill would permit certain attribution of activities between famiily members in the case of farming activities for the purposes of applying the material participation test.

Clarification is also needed, we believe, in regard to Section 2032A eligibility and participation in farm programs. The 1985 farm act established the Conservation Reserve Program which allows farmers to idle land under a ten-year contract with the Department of Agriculture. The technical revisions bill should make clear that individuals who place land into the CRP should continue to be considered "active participants" under Section 2032A.

The 1985 Omnibus Reconciliation Act provided minimum tax relief for insolvent farmers who are in the process of liquidating farm assets or transferring them to creditors. Such farmers would be allowed to reduce their capital gains preference by that percentage represented by the gain on the insolvency transaction. However, problems have arisen relating to the definition of "farmer", since in many cases debt restructuring and associated liquidation of property takes place, or should take place, over a period of years. The legislation, however, requires the insolvent farmer to earn at least 50 percent of his gross income from farming during the 3 preceeding tax years. The time period, we believe, should be broadened to 5 out of the previous 10 years in order to accommodate farmers who have been working with their lenders to restructure debt.

And, finally, we wish to ask the Congress for attention to a situation relating to final 1986 deficiency payments under the 1986 wheat program. Late in 1986 the Congress acted to advance the final payment under the "Findley Authority" of the 1985 farm bill from July 1987 to December 1986. The likelihood of the Congress taking action to advance the payment was uncertain, and therefore farmers were unable to accurately plan their 1986 tax payments. Further complicating the situation, even though the Congress took action to require the payments in 1986, USDA was unable to process a large number of final payments, inlcuding the "Findley" portion, until January 1987, and IRS will require payment of income taxes on those checks in 1987. Because of this confusion, we ask the Congress to provide for wheat farmers to elect the year in which they will pay income taxes on final 1986 deficiency payments.

Mr. Chairman, we appreciate your consideration of the views of the National Association of Wheat Grwoers in drafting revisions to the 1986 tax act.

Sincerely,

James W. Miller
President

Statement of the
National Council of Savings Institutions
On H.R. 2636
The Technical Corrections Act of 1987
Submitted to the
Committee on Ways and Means
U.S. House of Representatives
July 17, 1987

The National Council of Savings Institutions appreciates the opportunity to share our views on the Technical Corrections Act of 1987 with the Ways and Means Committee. The National Council is a trade association representing approximately 600 savings banks and savings and loan associations with total assets of $450 billion. Our members include institutions insured by both the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation.

INTRODUCTION

The National Council, on behalf of its member institutions, would like to take this opportunity to congratulate the members of the Ways and Means Committee on the successful enactment of the Tax Reform Act of 1986. The leadership exhibited by the Chairman and members of the Committee in guiding the legislation through the House of Representatives and the Conference with the United States Senate was largely responsible for the ultimate adoption of the landmark legislation.

As with any legislation of such sweeping nature, there are technical problems which surface as the Act is placed in practical application. The outstanding fact is that there are as few items to be corrected as have come to the forefront to date. These potential corrections, however, are of critical importance if the Tax Reform Act is to work successfully in the coming years. The National Council, therefore, will share our comments on issues we have identified which affect the ability of thrift institutions to operate under tax provisions relating to mergers and conversions, extension of "at risk" rules to foreclosed property and application of the rate structure and bad debt deduction.

CONVERSION OF THRIFT INSTITUTIONS UNDER THE FIRM COMMITMENT METHOD OF UNDERWRITING

The National Council supports the provisions contained in Section 106(d)(15) of the bill which make clear that in relation to thrift conversions, an underwriter of an offering of stock under the firm commitment method will not be treated as acquiring any stock of the thrift as long as the stock is disposed of purswant to the offer. The provision also stipulates that the stock must be disposed of no later than 60 days after the initial offering.

Council members have had difficulty obtaining opinions of counsel that net operating loss carryovers would survive a conversion from mutual to stock if it was completed under the firm commitment method of underwriting. The confusion was created by the inclusion of Footnote 7 in the Joint Explanatory Statement of the Committee of Conference for Title VI relating to corporate tax provisions (See: House Rep. 99-841, Volume II, Page 178). This footnote had raised questions of whether the underwriter would be a 5 percent shareholder by virture of the firm commitment offering, even though Federal Home Loan Bank Board and state regulations would prohibit the underwriter from owning or keeping a controlling interest in the stock of a thrift institution. Such a determination would have limited or resulted in the loss of net operating loss carryovers accumulated by the institution before the conversion. The inclusion of the aforementioned language solves the problems and allows conversion to move forward. We applaud the members of the committee and staff for drafting provisions removing the impediment.

The Council does ask that the final language of the bill or the Report accompanying the legislation make clear that the 60 day period required under the statute begins from the time of the firm commitment offering itself and not at the early point when a community offering is made to depositors of the mutual institution. Under banking regulations, mutual institutions are required first to offer options to purchase stock to depositors in the institution for a limited period of time (such as 45 days). If the offering is not fully subscribed by the depositors, the institution then moves forward to the public offering which may be completed using a firm commitment method of underwriting. This is the point at which the clock on the 60 day period should be triggered. While we understand that is the intention of the drafters of the provision that the 60 days apply to the firm commitment offering itself, we urge that this be made clear so that further confusion can be avoided.

INCLUSION OF SAVINGS BANKS IN TWO YEAR WINDOW PERIOD UNDER SECTION 382.

Section 106(d)(15) of the Bill makes clear the savings banks are included in the two-year window period allowed before the imposition of the new Section 382 rules limiting the use of net operating loss carryovers following a conversion. The Council is pleased that the Committee included this correction in the bill so that there will be no question regarding the application of the window period to savings banks.

SUPERVISORY CONVERSIONS AND MERGERS

There are a number of technical problems with the language contained in the Tax Reform Act referencing Section 382 of the Internal Revenue Code as it relates to supervisory conversions and mergers. The Council is pleased that the Technical Corrections Bill does make clear in Section 106(d)(8)(A) that the 20 percent test will be calculated by reference to the value of the deposits and will not require these deposits to have voting power. We also urge the Committee to correct other technical errors in these provisions. First, the Committee should preserve the "scale down" of previous law in regard to supervisory thrift mergers and conversions. It is our understanding that the intention was to extend the provisions of Section 382 in this area as they existed prior to the Tax Reform Act. Unfortunately, the "scale down" was dropped in the drafting. This provision needs to be corrected if FSLIC is to successfully continue to merge problem institutions.

Secondly, the National Council urges the Committee to draft changes to the Tax Reform Act and include provisions in the Technical Corrections Bill which will provide solutions to possible loss of carryovers in situations where the regulators create an interim association owned and operated by the deposit insuring agency until a buyer can be found. Previously, these steps were treated as successive "G" reorganizations and the tax attributes were maintined. This provision is especially important given the problems facing FSLIC in finding buyers for many of the problem institutions still in existence. It will be more necessary than ever for FSLIC to take such interim steps if it is to move foward with elimination of problem institutions.

EXEMPTION FROM EXTENSION OF AT RISK RULES TO SALE OF FORECLOSED PROPERTY

An area of concern for National Council member thrifts relates to provisions contained in Section 503 of the Tax Reform Act of 1986 which extended the "at risk" loss limitation rules to deductions resulting from real property acquired through the use of nonrecourse financing. While the Act contains exemptions from the rules for third party lenders ("qualified persons") relating to property which is security for nonrecourse loans, this provision does not extend to the sale by these lenders of property acquired through foreclosure. A related person may qualify for the exemption as long as any loan is "commercially reasonable" and made on the same basis as loans to unrelated persons. This exemption does not, however extend to loans where the seller is also the financer even if such a loan is completed on a commercially reasonable basis. The extension of the at risk rules to thrifts under these circumstances creates problems for these institutions as they dispose of foreclosed property.

The imposition of these rules could not have come at a worse time. Thrifts are in the process of restructuring and adjusting to declines in the real estate markets in certain geographic areas. In order to complete this process, thrifts must be able to move quickly to dispose of foreclosed property. They have traditionally financed the sale of their own properties. Now thrifts will be required to find alternative financing for the sale of these properties or face increased costs. This is a complicated problem given the economic conditions in some geographic areas and the restrictions under the laws of some states prohibiting recourse financing.

The National Council respecfully requests that this issue be addressed in the final version of the Technical Corrections Bill or in other legislation. One answer may be to extend the commercially reasonable standards applicable to related parties to the sale of foreclosed property by the lender. We will be more than pleased to work with the Committee to find solutions which will allow our members to more quickly and easily dispose of foreclosed property.

INTERRELATION BETWEEN THE THRIFT BAD DEBT DEDUCTION AND THE INVESTMENT TAX CREDIT

Section 109 of the Technical Corrections Bill provides steps for a thrift institution which made an election relating to the investment tax credit (ITC) under previous law, to modify the election and again be able to take advantage of the Section 593 thrift bad debt reserve. We are pleased that this language has been included in the bill. This remedies an inequity which would have penalized institutions for elections made before statutory provisons eliminating the ITC were enacted.

COORDINATION OF THRIFT BAD DEBT RESERVE AND 1987 TAX RATE

One area of concern to the National Council has been the jump in the corporate tax rate facing thrift institutions which are calendar year taxpayers and which are qualified thrift lenders for purposes of the bad debt deduction. This jump in the tax rate impacts calendar year thrift institutions only in 1987. It results from the timing of the phase-down of the 40 percent bad debt deduction to 8 percent beginning on January 1, 1987 combined with the delay in the reduction of the corporate tax rate from 46 percent to 34 percent until July 1, 1987. The resulting increased rate does not fit with the historical intent of the bad debt deduction as a rate modification to encourage investment in housing. The Council would hope that the Committee will agree to provisions which would eliminate this "spike" in the tax rate and which level the rate for 1987 at the 1988 rate.

CONCLUSION

The National Council appreciates the opportunity to share with the Committee our findings on the practical workings of the Tax Reform Act of 1986. We again wish to express our thanks for the consideration already given to several problems and for inclusion of solutions to these in the Technical Corrections Bill. We hope we can move as rapidly and as successfully to solve the additional problem items identified in this statement. The Council staff and members will be willing to work with the Committee to devise workable solutions to remaining areas. If Members of the Committee have questions regarding the provisions outlined in the statement or if the National Council can provide further information, please contact Beth Neese, Director of Tax Legislation, National Council of Savings Institutions, 1101 15th Street, N.W., Washington, D.C. 20515, (202) 857-3100.

WRITTEN STATEMENT OF THE NATIONAL GRANGE
PREPARED BY MARK C. NESTLEN, LEGISLATIVE REPRESENTATIVE
SUBMITTED TO THE HOUSE WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
JULY 17, 1987
re: H.R. 2636 - The Technical Corrections Act of 1987

The Tax Reform Act of 1986 was legislation whose time had come. The National Grange made tax reform a priority item in 1981 and most of our objectives were met in the 1986 debate. Of most importance to agriculture was the elimination of passive investment deductions for agriculture. Such deductions had biased the investment pattern in agriculture and had cost the U.S. Treasury millions of dollars. We commend this committee for the leadership exhibited in eliminating this abuse.

The National Grange supported passage of the Tax Reform Act of 1986 and contends that it will benefit the economy, particularly the agriculture economy which in turn will assist in revitalizing rural America. As with any legislation, however, there are a few problems that should be corrected. With that in mind, we welcome the introduction of the Technical Corrections Act of 1987 and this opportunity to share the views of the over 365,000 members of the National Grange in 42 states.

In the remainder of the statement we will comment on a few of the corrections contained in the corrections bill as introduced, on technical corrections not in the original legislation which should be contained in a technical package, and substantive changes which will improve the law.

TECHNICAL CORRECTIONS IN THE TECHNICAL CORRECTIONS ACT OF 1987

Agricultural Provisions

With regard to IV Agricultural Provisions (section 104 of the bill) the Grange has no concerns and supports the indicated changes as it also does for VII Accounting Provisions (section 108 of the bill) as it relates to the limitations on farming deductions.

Self-Employed Health Insurance Deductions

The National Grange disagrees with the proposed correction for the deductibility of health insurance costs of self-employed individuals (section 111B(b) of the bill, section 1161 of the Reform Act, and section 162(m) of the Code). The corrections bill would specify that the amounts deductible under section 162(m) do not reduce the income base for the self-employed individuals social security tax. We do not believe that it is equitable to allow employed individuals fringe benefits which do not add to the income base for social security purposes unless self-employed can reduce their income base by the amount deductible under section 162(m). The purpose of this provision was to develop a level field between the employed and self-employed. This was only partially achieved since only 25 percent of health insurance will be deductible for the self-employed. The recommended change in the correction bill will only further tilt the scale in favor of the employed.

TECHNICAL CORRECTIONS WHICH SHOULD BE INCLUDED IN THE TECHNICAL CORRECTIONS ACT OF 1987

Preproductive Period Expenses

The Tax Reform Act of 1986 makes certain changes for farmers electing to deduct preproductive expenses for livestock with a preproductive period of two years or more. The preproductive period is defined as from conception of the animal until the animal gives birth. This definition is practically and technically incorrect. The National Grange is not asking for repeal of this provision but asking that a true technical correction is made. The "two gestation" definition is inaccurate. The period needs to be accurately defined as from birth of the animal until the animal begins its useful activity. An example is placing a female in the breeding herd. Under the "two gestation" definition, there are actually three distinctly different management periods. From conception to parturition, the management practices relate to the care of the mother (cow, sow, ewe, mare). After birth until the female is placed in the breeding herd is a second stage of management. The management during this period relates to the growth and development of the animal itself. When the female is placed in the breeding herd, the care of that female is a production management and is similar to the care that her mother received during gestation. Therefore, the "true preproductive period" for livestock is from birth until placed in the breeding herd.

The simplest example to further substantiate the above claim is the nutrient requirements of the animal through the "two gestation" period. The following table will refer to the first gestation period as "Period 1", the "true preproductive period" (as defined above) as "Period 2", and the second gestation period as "Period 3". The examples will compare the daily nutrient need per animal for major nutrients of beef cattle.

DAILY NUTRIENT NEED

Nutrient	Period 1 (pregnant mature cow - 1,213 lbs.)	Period 2 (lactating cow - 1,213 lbs.)	Period 2 (heifer calf - 551 lbs.)	Period 3 (pregnant heifer - 937 lbs.)
Protein (kg)	.54	.97	.75	.88
Net Energy (growth) (Mcal)	N/A	N/A	4.84	3.03
Net Energy (maintenance)(Mcal)	8.75	11.9	5.37	7.21
Total Digestible Nutrients (kg)	4.2	5.6	5.4	5.3
Calcium (g)	16	28	27	19
Phosphorous (g)	16	28	21	19
Vitamin A (Thousands IU)	26	26	14	28

The table shows the distinct difference in nutrient requirements which result in different management practices. The Net Energy requirement for growth is higher for the "growth period" but the Net Energy requirement for maintenance is much higher for the pregnant heifer. This is indicative of preproductive growth in Period 2 as contrast to production maintenance in Period 3. In addition, the higher calcium requirement in Period 2 indicates growth is at its maximum, further showing this is the "true preproductive period". It is true that there is a major change in nutrient requirements from the pregnant cow to the lactating cow. However the increase in requirements for the lactating cow is attributable to the preproductive growth of the calf.

Growth, as measured by increase in body weight, is at its most rapid rate early in life. When expressed as a percentage increase in body weight, the growth rate declines gradually until puberty, followed by an even slower rate until maturity. As animals grow, different tissues and organs develop at differential rates and it is quite obvious that the conformation of most newborn animals is different from that of adults; this differential development has, no doubt, some effect on changing nutrient requirements.

Dry matter consumption for all young animals is usually far greater per unit of body weight during their early life than in later periods. This high level of feed consumption provides a large margin above maintenance needs, thus allowing a high proportion to be used for growth and development of the young animal. Due to differences in the capability of the GI tract for food utilization and because the rate, duration, and character of body growth varies with age and animal species, nutrient requirements may be quite different for different animal species. Nevertheless, it is characteristic for all species that nutrient requirements (in terms of nutrient concentration/unit of diet) are higher for the very young and then decline gradually as the animal matures. Naturally, total food and nutrient consumptions is less for young animals because of their smaller size.

Although the nutrient needs of animals for reproduction generally are considerably less critical than during rapid growth, certainly they are more critical than for an adequate level of maintenance. If nutrient deficiencies occur prior to breeding, they may render animals sterile, or result in low fertility, silent estrus or failure to establish or maintain pregnancy.

Additional practical problems exist and the Grange asked the Department of the Treasury to write regulations to clarify the problems. In a December 18, 1986 letter from National Grange Master Edward Andersen to Treasury Secretary James A. Baker, III, Andersen made the following remarks:

> "Moving to the first gestation period, the question must be answered 'When does the period start?'. Modern animal husbandry practices create a problem as to when the first gestation period of the 'two gestation' definition would begin. In livestock, the frequency of natural mating is decreasing and artificial mating is increasing. While we can state that the gestation period for cattle is 283 days, the length of the period could be changed with differing management practices.
>
> "If artifical insemination is used, a 'clean-up bull' (a pasture bull which rebreeds cows if the cow does not conceive when artificially inseminated) will breed the cows usually with no supervision; thus, making it impossible for a rancher to know when and if the 'clean-up bull' breeds the cow.
>
> "Embryo transplants have become a common practice in livestock production. Does the preproductive period, as currently defined, start when the donor cow is flushed or when the recipient cow has the embryo implanted? If an embryo is frozen (a common practice) for a period of time, does the period start when the donor cow is flushed, when the egg is removed from freezing, or when the recipient cow is implanted? If an embryo is split (becoming a more common practice to produce identical twins), does the period start when the donor cow is flushed, when the embryo is split (two new animals have been created), or when the recipient cow is implanted? If the period is not redefined, we believe the period in all cases should start when the recipient cow is implanted."

In an attempt to address these concerns, the Department created a discriminatory situation between different types of producers who use different management practices. Some producers would come in under the two-year period while their neighbor, due to a slightly different management practice, would fall outside the period. In response to the proposed regulations in a letter of May 27, 1987, to the Commissioner of the IRS, Lawrence B. Gibbs, National Master Andersen said the following:

> "As defined in the proposed rule, 'The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation. The preproductive period ends at the time the animal is ready to perform the primary function intended to be performed by that animal (e.g., when the animal becomes productive in marketable quantities), or when the animal is reasonably expected to be sold or otherwise disposed of. For example, in the case of a cow used for breeding purposes, the preproductive period with respect to the cow ends on the date the first calf is dropped.'
> This definition not only ignores the management practices described above but is also discriminatory.

"Ranchers who purchase calves will have an unfair advantage over a rancher who raises his/her own calves. The period for the cattle producer who purchases his/her calves will not begin until he/she acquires the calves whereas the period for producers who raise his/her own calves will begin at conception. This could mean two neighboring ranches could fall under different tax regulations - one could deduct preproductive expenses while one would be forced to capitalize the same expense.

"Similarly, a producer who sells calves will have an unfair advantage over a producer who retains calves for breeding purposes. If a rancher sells calves under the two-year deadline, he/she could deduct the preproductive period expenses while a rancher who retains heifers for the breeding herd would be forced to capitalize the same expenses.

"Additionally, bull calves are determined to have a different preproductive period than heifer calves. Males do not have a second gestation period. This then, indicates that the preproductive period for the male would end when he can impregnate a female - his intended function. Therefore, a female's period should also end when she can be impregnated, or, in other words, placed in the breeding herd. Unless this is done, two sets of requirements will be necessary, causing problems for both the rancher and the IRS.

"The above examples referred to cattle, however, the same scenarios can be made for other species of livestock. As you can see, these regulations create a distorted playing field placing some livestock producers at a competitive advantage over others. Accurately defining the period will help to correct the majority of this problem."

Another problem involved in this provision is the different depreciation schedule for producers who elect not to capitalize. While this is not a technical correction as the definition of the period is, it should be changed.

Under (vi) Special rules for treatment of expenses (B), it states that: "If the taxpayer or a related person makes the election, the alternative depreciation system (as defined in section 168(g)(2)), shall be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect." This needs to be narrowed in scope. In a diversified operation, only assets relating to the preproduction expense should be required to use straight line depreciation method and not all farm assets.

Once again, these regulations tilt the playing field, this time for wheat, corn, etc.. While most farmers will be allowed to use a form of accelerated depreciation, a select few will be punished for diversifying their operation - a recommended practice to avoid economic downturns.

As you can see, with modern practices not only is it indefensible to start the preproductive period when the mother conceives because the management during the mother's pregnancy is a production management directed to the mother and not the animal itself, but it is also impossible to have a rule that indicates when the first gestation period starts. This is obviously a pure technical correction and should be included in the bill. (Many lawmakers have introduced legislation to solve this problem.)

Passive Loss Deductions Under the Minimum Tax

The Tax Reform Act of 1986 created an individual minimum tax preference for "losses from passive farming activities". This preference is largely inefficient because similar amounts are included under the general preference item for "net loss from passive trade or business activities". This special treatment for agriculture could become confusing, is unnecessary due to the strong passive loss rules, and should be eliminated.

Family Attribution For Material Participation

The Tax Reform Act of 1986 provided certain restrictions on passive investment losses where a taxpayer did not "materially participate" in a trade or business activity. The use of agents to run day-to-day operations is allowed in the law. The Grange believes that a family member is a special type of agent. We suggest that the technical package clarify that for the purpose of the passive loss rules that activities of one family member be attributed to another. Specifically, a taxpayer who "actively participates" in a farming activity should be attributed the activities of a family member for the purpose of determining if the taxpayer "materially participates" if such taxpayer would be attributed the activities of a family member pursuant to section 2032A of the Code. The definition of "farming activities" would also be consistent with the definition of "farming purposes" in section 2032A. The term "active participation" would have the same meaning as otherwise provided in the Tax Reform Act of 1986.

Crop Share Lease For Material Participation

The Grange recommends that the technical correction legislation clarifies that in a crop share lease where the lessor materially participated in the operation that such lessor should not be subject to passive loss restrictions for that activity and that a crop share lease is not to be treated similar to rental activities if the lessor materially participates.

In the case of agriculture, various lease arrangements of farm property may exist, including a traditional cash lease arrangement or a "crop share lease". In the case of the "crop share lease", there exists an arrangement whereby the lessor is committed to various obligations in return for a portion of the lessee's crop or proceeds from that crop.

In the case of some crop share leases, the lessor provides substantial personal services as well as property. In such case, the lease describes a trade or business arrangement more than it does a simple rental arrangements for tangible property. This unique quality of some crop share leases has led to various rulings and cases whereby the lessor's income is considered net income for the purposes of computing the self-employment tax.

Indeed, such cases are the basis for much of the current caselaw and rulings related to the definition of "material participation". These cases and rulings have held that where a lessor in a crop share lease arrangement materially participates in the farming activity that the income from the lease will be considered to be self-employment income.

In leading ruling in this area, it was held "that . . . as a general rule, each case must be decided upon its own facts and circumstances. It may be stated, however, that a landowner, who establishes that he (1) periodically advises or consults with the other party (lessee) regarding the production of the commodity, (2) periodically inspects the production activities on the land, *and* (3) furnishes a substantial portion of the machinery, implements and livestock used in the production activities, or furnishes or advances funds or assumes financial responsibility for a substantial portion of the expense involved in the production of the commodity should include the income . . . in computing net earnings from self-employment [and thus should be deemed to materially participate]." Rev. Rul. 57-58 (*emphasis added*).

The analogy to the "material participation" standard in the passive loss rules in the Tax Reform Act of 1986 is both obvious and necessary. During consideration of the legislation, the "material participation" standard as applied to agricultural activities was generally discussed by reference to section 2032A of the Code, which defines "material participation" by reference to the self-employment tax question. *See*, section 2032A(6) of the Internal Revenue Code of 1986.

Also, the Conference Report for the Tax Reform Act of 1986, while not dealing with crop share leases directly, contained language which would imply that in a crop share lease where the lessor materially participated in the operation that such lessor should not be subject to the passive loss restrictions for that activity. First, special language was included to suggest that where a taxpayer is engaged in the decision making of a farming activity, that such taxpayer will be deemed to materially participate similar to the holding in Rev. Rul 57-58. *See*, Conference Report at 11-148.

Also, the Conference Report noted that "[i]t is clarified that a rental activity may include the performance of services that are incidental to the activity . . .. However, if a sufficient amount of such services are rendered, they may rise to the level of a separate activity, *or the entire activity may not constitute a rental activity under the provision." Id.* (*emphasis added*).

Taxation of Conservation Reserve Program Payments

The Internal Revenue Service has made a misinterpretation of congressional intent for self-employment taxation on rental payments. In the Food Security Act of 1985, Congress established a ten-year acreage set-a-side program, the Conservation Reserve Program (CRP), to conserve our nation's vital resource, soil. In return for discontinuing production on highly erodible land the Secretary of Agriculture reached agreements on a level of rental payments to be paid to the producer by the Department of Agriculture.

To ensure that there would be no misunderstanding about the CRP payments, the farm bill conferees included language in the conference report that clarified the definition of a rental payment. The farm bill conferees concurred that:

> ". . . 'rental payment' mean(s) a payment made by the Secretary to an owner or operator of a farm or ranch containing eligible highly erodible cropland to compensate the owner or operator for retiring such land from crop production and placing such land in the conservation acreage reserve."

The Conference report also defined conservation payment as reimbursement for the cost of cultivating ground cover or grasses to replace the crop that had been grown on the land. However, the CRP payment is specifically and repetitively referred to as a rental payment from the Secretary to the farmer because the Secretary and the farmer entered a contractual agreement in which the farmer agrees to rent his highly erodible land to the Secretary in exchange for annual rental payments.

As self-employed workers, farmers are required to contribute to the Social Security system under the terms of the Self-Employment Contributions Act [SECA]. Section 1402(a) of the Internal Revenue Code defines net earnings from self-employment for SECA tax purposes and stipulates that agricultural rental payments are excluded from net earnings if the renter does not "materially participate" in production on the land. Therefore, for a farmer who rents his property to another farmer and has no involvement in the production of the land, the rental payments are not considered earned income for SECA purposes. IRS has determined for a farmer who participates in CRP and is clearly not involved in production of the land, the rental payments he receives from the Secretary are treated as earned income. However, the Social Security Administration ruled that CRP payments are not earned income for the purposes of the earnings limitation for Social Security retirement benefits.

Clearly the IRS ruling is contradictory to the SSA determination and the intent of Congress. This is not a technical correction of the '86 tax bill but should be included in the technical tax corrections bill since, as introduced, other tax legislation is corrected in the Technical Correction Act of 1987. (Legislation has been introduced to correct this misinterpretation.)

SUBSTANTIVE CHANGES

While H.R. 2636 deals with technical changes, parts of the bill make substantive changes and the National Grange strongly believes that if the law can be improved it should be done.

Depreciation Schedules on Single-Purpose Agricultural Structures

The National Grange supports lengthening the depreciation schedule on single-purpose structures to 15 years. During the '86 debate the House language called for 13 years, the Senate language called for 10 years, and the Conference agreed to 7 years. Any schedule shorter than 15 years simply encourages tax incentive production. (Legislation has been introduced to accomplish this.)

Self-Employed Health Insurance Deductions

The National Grange urges Congress to remove the sunset clause on the deductibility of health insurance costs of self-employed individuals and to raise the deductibility amount from 25 percent to 100 percent. The goal, as stated in part 1 of this testimony, was to establish an equity between self-employed paid insurance and employer paid fringe benefits. The above recommendation needs to be implemented to achieve this goal. (Legislation has been introduced to accomplish this.)

Cash Accounting

The National Grange believes that a cap on the use of cash accounting will help to control the abuse of the privilege. The cap should be high enough to allow traditional family farms to benefit from its usage and low enough to restrict its usage by large corporations. Further, the use of cash accounting should be eliminated for taxpayers engaged in related food processing activities.

Prepaid Expenses

The prepaid expense provision which limits the use of cash accounting for farmers should be eliminated. The provision passed in the Tax Reform Act of 1986 was changed in the final draft before passage to improve the provision but it still restricts the use of cash accounting for farmers for farming expenses to the extent that such prepayments exceed 50 percent of total deductible farming expenses including prepaid supplies. This provision was included to assist in removing passive investors from agriculture. However, it is unnecessary due to the strong material participation language in the law. This provision can have an adverse effect on true family farmers and should be eliminated. (Legislation to accomplish this has been introduced.)

Income Averaging

The National Grange recognizes the importance of income averaging to agriculture. Given the variance of weather, crop prices, and other factors that are beyond the control of farmers and ranchers, their incomes can fluctuate widely. These fluctuations can unfairly exaggerate tax liabilities by forcing farmers, during good years, to pay higher taxes than their long term earning power warrants. We do believe that eliminating the use of income averaging for those people with continuously rising incomes is correct. However, the use of income averaging by family farmers is extremely important. (Legislation has been introduced to reinstate income averaging by a number of lawmakers.)

CONCLUSION

The implementation of the above recommendations, both technical and substantive, will improve the tax bill passed in 1986. The tax writing committees are to be commended for the leadership in developing legislation which will place American agriculture in a more competitive setting.

NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

COMMENTS ON H.R. 2636

THE TECHNICAL CORRECTIONS ACT OF 1987

The National Telephone Cooperative Association (NTCA) is a national trade association dedicated entirely to representing and serving the interests of the nation's rural independent telephone systems.

A non-pofit trade association, NTCA today represents more than 450 small, independent cooperative and commercial telephone companies located in 42 states. More than five million consumers get their telephone service from NTCA members systems.

NTCA respectfully requests that the Technical Corrections Act of 1987 be amended so non-exempt rural telephone cooperatives are allowed to treat patronage dividend allocations as a reduction in determining net book income and so tax-exempt telephone cooperatives are allowed to offer 401(k) retirement plans to their employees.

Background on Rural Telephone Cooperatives

Congress amended the Rural Electrification Act in 1949 with the goal of providing affordable telephone service throughout the country. Most telephone cooperatives began in the 1950's with little equity and were boot-strap organizations with the goal of achieving self-sufficiency. Because the cost of providing telephone service to low density rural areas was not economically attractive, most large telephone companies could not - or would not - provide service to these areas. With financial assistance from REA, cooperatives were formed throughout the country to provide telephone service primarily in sparsely populated rural areas.

Telephone cooperatives had two important means to generate the necessary financing to assist them in providing telephone service. First, cooperatives are able to secure equity capital from their members. Second, there was the REA loan program. Generally, cooperatives have retained the equity capital and then paid it back to subscribers in the form of patronage dividends when financial conditions warrant. Unlike regular corporate profits, the amount above the operating costs of the cooperative are not profits or earnings but are capital contributed by the members and therefore not taxable.

Problems faced by rural telephone cooperatives continue today and, in some ways, are more difficult than ever:

Low Density - REA borrowers serve rural areas that have an average of only five customers per mile of telephone line, while the Bell Operating Companies have approximately 130 customers per square mile, and all telephone companies average 50 customers per mile.

Financing - Telephone cooperatives have traditionally received most of their financing from REA loans. While the expense of providing telephone service to rural areas remains high, REA financing may become difficult to obtain. The REA loan levels have been frozen for the last ten years and the program itself has been targeted for elimination by this Administration. It is difficult for telephone cooperatives to obtain long term financing from commercial lenders. Today the average equity of REA cooperatives is 30%, well below the 40% to 60% debt-equity ratio required by commercial lenders.

Deregulation - Deregulation of the telephone industry has brought about several major policy shifts which could reverse or diminish historical revenue and income growth trends. The phase-out of settlements among states, competition for service to selected customers and the shift in allocation and recovery of costs could provide less revenue for local telephone companies.

In the competitive, deregulated environment, local telephone companies are asked to provide more sophisticated services. For example, technological advancements have created the need for digital switching to provide equal access to alternative long distance carriers and to provide many of the new custom calling services sought by subscribers. Underground cable provides more reliable, higher quality transmission and is needed to reduce maintenance and frequent outages caused by the harsh weather conditions in many rural areas. With the help of the REA telephone loan programs, rural telcos are able to replace obsolete equipment in order to provide better services to their customers.

Taxation of Cooperatives

Most cooperatives are qualified for tax-exemption under Section 501(c)(12) of the Internal Revenue Code. This section states that a cooperative that provides telephone service to rural areas is tax-exempt only if 85% or more its income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

If the telephone cooperative cannot meet this requirement, it loses its tax exempt status under Section 501(c)(12). The non-exempt cooperative would be taxed on revenues received as interest or rental income or gains on the disposition of a capital asset as well as any revenue not received from its patrons.

If a telephone cooperative is non-exempt from income tax under Section 501(c)(12), it is subject to the same treatment as any other taxpayer with respect to computation of taxable income, with one important exception: a cooperative may exclude allocations of patronage credits if it meets all of the following requirements for non-profit operations as set forth in Farmers Cooperative Co. v. Birmingham, 33 TC 266 (1959):

. . .

> ...an allocation of earnings by a cooperative to its patrons cannot qualify as a true patronage dividend unless:
>
> (1) the allocation was made pursuant to a legal obligation which existed at the time the participating patrons transacted their business with the cooperative;
>
> (2) the allocation was made out of profits or income realized from transactions with the particular patrons for whose benefit the allocation was made; and,
>
> (3) the allocation of earnings was made ratably to the particular patrons whose patronage created the income from which the allocated refund was made.

IRC Section 552, which was repealed by Subchapter T, allowed exempt farmer cooperatives to deduct or exclude the face value of credits allocated to patrons. Subchapter T specifically changed this for farmer cooperatives who were subject to its rules but excluded telephone cooperatives. Senate and House reports on the adoption of Subchapter T state that Subchapter T also does not apply to cooperative organizations "which are engaged in furnishing electric energy, or providing telephone service to persons in rural areas. These will continue to be treated the same as under present law." Sen. Rep. No. 87-1881; 1962-3 C.B. 707, 819, House Rep. No. 87-1447; 1962-3 C.B. 405, 483.

No other provision dealt with the deduction of patronage credits by cooperatives. But, longstanding administrative policies, court cases and revenue rulings stated that before enactment of Subchapter T cash and non-cash patronage credits paid or allocated under a pre-existing obligation were deductible by cooperatives, regardless of whether they were includable in income by the patrons. See, Farmers Cooperative Company v Commissioner, 228 F 2d 315 (8th Cir. 1961).

The court decisions justify exclusion of patronage dividend (or credits) on the basis that:

a. The cooperative is a mere agent for the patrons and serves only as a conduit for the income of the patrons, or;

b. Patronage dividends represent a price adjustment in the cost of goods, analogous to discounts and rebates given by a seller at the time of sale or upon prompt payment.

Another legal basis for excluding patronage allocations is that the patron has received the money in the face amount and has reinvested the amount in the cooperative's capital pursuant to the by-laws or some other contract. (See Rev. Rul. 54-10; Rev. Rul. 55-56, 1955-1, CB 282; Rev. Rul. 57-59. Also "Model By-laws for Telephone Cooperatives," Section 1101 of REA Telephone Operations Manual).

A non-exempt telephone cooperative may exclude from taxable income all amounts of operating income received from patrons. This is allowable because, as mentioned above, there is a pre-existing mandatory obligation to return such amounts to the patrons or to account for the amounts as the property of the patrons.

Telephone cooperatives do not pay tax on their margins and patrons' capital, whether paid in dividends or allocated to patrons' capital accounts. This is essential to their ability to obtain the necessary capital to provide telephone service in rural areas. Tax-exempt treatment of patronage credits is a valuable supplement to whatever funding is obtained from REA.

Request for Technical Correction Relating to Alternative Minimum Tax

The alternative minimum tax subjects a portion of a non-exempt cooperative's patronage capital contributions to taxation through the book income adjustment provision. This is inconsistent with the legislative history and case history of the taxation of non-exempt rural telephone cooperatives. Taxation of capital credits would hinder cooperatives from attaining sound financial status at a time when they are striving for self-sufficiency. The result would be to increase the need for federally financed loans to provide telephone service to rural areas.

When an investor purchases stock in a company, he or she is not taxed nor is the company taxed on the capital. It is inappropriate to subject capital to income tax and therefore a cooperative's patronage capital contributions should not be taxed.

To subject a cooperative's patronage capital contributions to taxation would impede our country's goal of making affordable telephone service universally available to persons in rural areas with quality equal to that of urban telephone services. We have a national telecommunications system. If people in urban areas are to communicate with residents and businesses of rural areas, the quality of the system must be maintained.

NTCA requests that the Technical Corrections Act of 1987 include a provision allowing non-exempt telephone cooperatives to exclude patronage capital contributions when determining the cooperative's adjusted book income. Congress recognized the fact that a cooperative's patronage capital contributions should not be subject to the alternative minimum tax when it excluded farmers marketing cooperatives defined under Section 1381 of the IRC from including the patronage allocation in determining book income. NTCA requests that the following language amending Sec. 56(f)(2) of the IRC be included in the Technical Corrections Act of 1987:

> any corporation operating on a cooperative basis and and described in Section 1381(a)(2)(c) shall treat any allocation which is in the nature of a patronage dividend as a reduction in determining the corporation's net book income.

Request for Technical Correction Relating to 401(k) Retirement Plans for Employees of Rural Telephone Cooperatives

The Tax Reform Act of 1986 eliminated the ability of tax-exempt organizations to offer 401(k) retirement plans to their employees if they had not done so by July 2, 1986.

Congress recognized that rural cooperative utilities must compete with commercial companies for qualified employees with very specific, technological skills when they included a provision in the Tax Reform Act of 1986 which allowed rural electric cooperatives that are tax-exempt under Section 501(c)(12) of the IRC to continue to offer 401(k) plans to their employees. Rural telephone cooperatives are also defined under Section 501(c)(12).

Small rural telephone cooperatives must compete with much larger commercial companies for technically qualified staff. Under the tax code, commercial companies are able to offer a variety of profit-sharing and deferred compensation plans in addition to comparatively higher salaries. Like rural electric cooperatives, rural telephone coperatives are non-profit, tax exempt organizations and are unable to offer profit-sharing or stock option plans.

Rural telephone cooperatives must be able to offer complete compensation packages to attract qualified employees. One of the most popular savings programs for employees of telephone cooperatives has been the 401(k). Under

Section 401(k) an employee may elect to defer a part of compensation and place the deferred amount in a section 401(k) plan set up by the employer. The deferred compensation is not subject to federal income tax until it is paid to the employee. The plan has allowed both management and rank-and-file employees to provide for their own retirement.

Based on the participation rate of telephone cooperative employees who are unable to take advantage of 401(k) plans, it is anticipated that 2300 people nationwide would be allowed to take advantage of 401(k) retirement savings plans. Because of the minimal number of persons affected by this amendment, it is anticipated that there will be negligible revenue impact.

NTCA requests that the Technical Corrections Act of 1987 reconcile the inadvertent omission of telephone cooperatives as relates to Section 401(k) of the IRC by the inclusion of the following language:

> SECTION 1. RURAL TELEPHONE COOPERATIVES PERMITTED TO HAVE QUALIFIED CASH OR DEFERRED ARRANGEMENTS.
>
> (a) IN GENERAL. -- Paragraphs (1) and (2) of section 401(k) of the Internal Revenue Code of 1986 (relating to cash or deferred arrangements) are each amended by striking out "or a rural electric cooperative plan" and inserting in lieu thereof "a rural cooperative plan."
>
> (b) RURAL COOPERATIVE PLAN DEFINED. -- Paragraph (7) of section 401(k) of such Code is amended to read as follows:
>
> > "(7) RURAL COOPERATIVE PLAN. -- For purposes of subsection, the term 'rural cooperative plan' means any plan --
> >
> > (a) which is a defined contribution plan (as defined in section 414 (i), and
> >
> > (b) which is established and maintained by a rural electric cooperative (as defined in section 457(d)(9)(B), a cooperative telephone company described in section 501(c)(12) or a national association of such cooperatives."

COMMENTS OF THE
NATIONAL TOOLING AND MACHINING ASSOCIATION
REGARDING THE
TECHNICAL CORRECTIONS ACT OF 1987
(H.R.2636, S.1350)

The National Tooling and Machining Association supports the clarification that disallowed costs under expensing provisions (sec. 201(d) of the Reform Act and sec. 179 of the Code) may be carried forward an unlimited number of years.

We support the provision allowing 90 days after the enactment of this bill for stock options to be amended so that they may be treated as incentive stock options.

We suggest transition rules for the $25,000 active participation requirements for rental real estate activities and for the definition of "active participation." Taxpayers exceeding the $25,000 limitation are placed at an unfair disadvantage if they are penalized on one hand by the tax code if they do not come immediately into compliance and on the other by the marketplace if they dispose of property in an unfavorable market in order to bring themselves back under the $25,000 limitation.

We suggest that active participation rental real estate losses be limited to the greater of $25,000 or 90% of the prior year's active participation real estate losses, also with a three year phase-in.

While not a technical correction, we continue to believe that it is unfair to tax homeowners on amounts refinanced in excess of the original cost of the home. The provision effectively prevents any refinancing in many cases since points and other loan costs may be prohibitively high in comparison to the non-taxable equity in the home. We also suggest that the provision be changed to apply only to homes purchased after the enactment of the 1986 tax act.

We appreciate provisions overturning IRS Notice 87-8, which has blocked taxpayers from using income from installment sales entered into before 1987 to offset losses from passive activities.

We believe there should also be a transition rule for capital gains. Capital appreciation occurring before the enactment of the 1986 tax act should be taxed at a level commensurate with what the taxpayer's 1986 effective capital gains rate would have been upon disposition of the property, with the balance taxed under the new capital gains rate.

The elimination of personal interest deductions under the 1986 tax act unfairly penalizes taxpayers with existing financed personal debts prior to the enactment of the law and who were not in a position to repay those debts in full. As a transition rule, we suggest that interest deductions on personal debts incurred prior to the enactment of the proposal be grandfathered.

We believe the completed contract provisions (sec. 804 of the 1986 act) will impose undue accounting burdens on small firms. We suggest that small businesses, as defined by Small Business Administration size standards, be exempted from those provisions of the 1986 tax act.

We hope that the Committee finds these suggestions useful.

Explanation of Proposed Technical Corrections to the Tax Reform Act of 1986 for Peabody Place, Memphis, Tennessee

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I. General Explanation

The Peabody Place project--the "Project"--is an extensive and very complex urban renewal development with a projected cost in excess of $190 million to be located in downtown Memphis, Tennessee. It was originally planned in 1983 and early 1984, well before any tax reform deliberations. Commencement of the Project was delayed, however, pending approval of a UDAG grant from the Department of Housing and Urban Development which was essential to its financing. Because of the substantial economic benefits which this Project would bring to the city of Memphis and the State of Tennessee, and because the Project would be seriously (if not fatally) jeopardized by loss of the anticipated ACRS depreciation benefits (which unquestionably were available when the Project was planned in 1983-84), transition relief was granted under the Tax Reform Act of 1986 . This relief was intended to ensure the continued feasibility of the Project; however, the relief provision contained in Section 204(a)(1)(G) of the Tax Reform Act of 1986 applies only to buildings (and property with a class life of 20 years or more) placed in service before January 1, 1991, a termination date which was not included or contemplated in the relief request.

Because of the enormity of this undertaking and the complexity of the financing (which may include a second round of UDAG financing currently under consideration by HUD), it will not be possible to place any of the Project buildings in service before 1991, although construction will be underway by that date. Thus, the 1990 cut-off date would render the current transitional relief provisions futile and frustrate the clear Congressional intent to preserve this Project. The attached proposed technical correction would provide a three-year extension (to December 31, 1993) of the current relief. These three years are vital to permit completion of the project, and a shorter extension would be of little use. Moreover, because it was contemplated by the Congressional sponsors that the current transitional relief provisions would grandfather the entire project under ACRS, an extension of the 1990 date to accomplish this result should not result in any revenue loss in excess of the amounts projected for the current rule under the assumption that the project could be placed in service in time.

It should be noted that an identical cut-off date of December 31, 1990 is also included in transitional relief provisions with respect to the tax-exempt bond financing of the Peabody Place project. Requests which have been submitted to extend these transitional relief provisions through 1993 have now been withdrawn by the sponsors in order not to detract in any way from the urgency and availability of the depreciation relief which is critical to the project and in order to emphasize the need for a full three-year extension of that rule.

In addition, a second technical correction is needed to remedy an enrolling error in the Tax Reform Act which also impacts on the Peabody Place project. A transitional rule originally contained in Section 702(m)(16) of H.R. 3838 was adopted in slightly altered form by the Conference Committee as paragraph (9)(A) of Section 1317 contained on Page I-636 of the Conference Report accompanying H.R. 3838, passed by both the Senate and the House of Representatives. This provision was inadvertently omitted from the enrolled version of the Tax Reform Act, and a technical correction to restore the omitted provision was included in H. Con. Res. 395 which was passed by the House on September 25, 1986, but was never adopted by the Senate. The relief provision would preserve the status of a parking garage to be constructed in connection with the Peabody Place Project as an "exempt activity" qualifying for tax exempt financing under the provisions of the 1986 Tax Reform Act.

II. Proposed Technical Correction Language

A. Section 204(a)(1)(G) of the Tax Reform Act of 1986 is amended by adding the following new sentence at the end thereof:

> For purposes of this subparagraph, Section 203(b)(2) shall be applied by substituting "January 1, 1994" for "January 1, 1991."

B. Section 1317 of the Tax Reform Act of 1986 is hereby amended as follows:

Paragraph (48) is amended by adding a new subparagraph (C) thereto which shall read as follows:

> (C) A facility is described in this subparagraph if it is part of a project described in paragraph (6)(O). The aggregate face amount of bonds to which this subparagraph applies shall not exceed $20,000,000.

(ii) a feasibility report dated October 1980 with respect to such facility was presented to a city or county in which such facility is to be located, and

(iii) on September 7, 1982, a joint city/county resolution appointed a committee which was charged with the task of independently reviewing the studies and present need for the facility.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $60,000,000.

(D) A sports or convention facility is described in this subparagraph if—

(i) such facility is a multipurpose coliseum facility for which, before January 1, 1985, a city, an auditorium district created by the State legislature within which such facility will be located, and a limited partnership executed an enforceable contract,

(ii) significant governmental action regarding such facility was taken before May 23, 1983, and

(iii) inducement resolutions were passed for issuance of bonds with respect to such facility on May 26, 1986.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $25,000,000.

(9) PARKING FACILITIES.—A bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide a parking facility (within the meaning of section 103(b)(4)(D) of the 1954 Code) shall be treated as an exempt facility bond for purposes of part IV of subchapter B of chapter 1 of the 1986 Code if such facility is described in any of the following subparagraphs:

(A) A facility is described in this subparagraph if—

(i) there was an inducement resolution on March 9, 1984, for the issuance of bonds with respect to such facility, and

(ii) such resolution was extended by resolutions passed on August 14, 1984, April 2, 1985, August 13, 1985, and July 8, 1986.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $30,000,000.

(B) A facility is described in this subparagraph if—

(i) such facility is for a university medical school,

(ii) the last parcel of land necessary for such facility was purchased on February 4, 1985, and

(iii) the amount of bonds to be issued with respect to such facility was increased by the State legislature of the State in which the facility is to be located as part of its 1983-1984 general appropriations act.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $9,000,000.

(C) A facility is described in this subparagraph if—

(i) the development agreement with respect to the project of which such facility is a part was entered into during May 1984, and

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July 22, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office
  Building
Washington, D.C. 20515

Re: Technical Issues Relating to
Section 936 Corporations

Dear Mr. Leonard:

The following is submitted for the record on H.R. 2636 on behalf of the Puerto Rico, U.S.A. Foundation.

The Tax Reform Act of 1986 contains a number of amendments and provisions other than section 936, the impact of which on section 936 corporations is unclear. In addition, a transitional rule is needed to phase-in the impact of increasing from 65 percent to 75 percent the amount of gross income from an active trade or business that is required for a corporation to obtain section 936 treatment.

The following are those items that we believe should be included in H.R. 2636:

1. Definition of Creditable Foreign Tax.-- Section 56(f)(2)(F)(ii)(I) provides that 50 percent of any withholding tax paid to a possession of the United States with respect to dividends that are added to adjusted net book income is treated as creditable foreign tax paid by the corporation receiving the dividends. In most cases, distributions from section 936 corporations that are dividends are subject to a withholding tax, and thus, a foreign tax credit is allowed under this provision. There are some cases where the recipient of a dividend is engaged in a trade or business in Puerto Rico and the dividend is not subject to a withholding tax, but is subject to the regular corporate Puerto Rican income tax at a reduced rate. The effective rate on this dividend approximates that which would be imposed if a withholding tax had been imposed rather than the Puerto Rican corporate income tax. Technically, however, the tax that is imposed is not a withholding tax and thus, a foreign tax credit would not be allowed for these taxes. A technical amendment is necessary to make clear that all Puerto Rican income taxes on dividends may be credited for alternative minimum tax purposes.

2. Computation of Foreign Tax Credit Limitation.-- Section 59(a)(1)(C) provides for an adjustment to the foreign tax credit limitation in case the alternative minimum taxable income is increased by reason of the book income

preference. It is provided that the increase in alternative minimum taxable income by reason of the book income preference is to be prorated between domestic and foreign sources based upon the portion of the alternative minimum taxable income from domestic and foreign sources before the book income adjustment.

In the case of other preferences, alternative minimum taxable income from sources outside the United States is calculated by determining gross income from foreign sources and by allocating and apportioning a portion of expenses to that gross income. Since in many cases the nature of the items that are included in book income are not identifiable as to source, a rule of administrative convenience was adopted which provides that the ratio of foreign to domestic source is not affected by the inclusion of the book income preference. In the case of a dividend from a possessions corporation which is included in alternative minimum taxable income, foreign source income is increased by an amount that equals the amount of the dividend multiplied by the ratio of foreign to domestic source income.

If the book income is attributable to possession source dividends, then the failure to increase the ratio of foreign to domestic source income may result in a loss of credits for taxes paid to Puerto Rico. An extreme example of this would be a parent corporation that has no foreign source income other than possessions corporation dividends. In such a case, the parent would have no foreign source income before the book income adjustment and thus, the book income adjustment would be all attributable to domestic source income and there would be zero foreign tax credit limitation. While this is a problem only under the book income preference, since the earnings and profits adjustment does not contain such a proration rule, the impact could be severe to affected taxpayers. Accordingly, we recommend that the statute be amended to provide that in no event shall the increase in foreign source income be less than the amount of dividends received from all possessions corporations.

3. Interest on Puerto Rico Government Obligations.--In the case of a section 936 corporation, the alternative minimum tax does not apply to (i) taxable income from the active conduct of a trade or business in the possession or from the sale of assets of such trade or business and (ii) gross income from sources within the possession that is from the investment in the possession of funds derived from the active trade or business or from other qualified investments (QPSII). The application of this exclusion to interest on Puerto Rico government obligations is unclear. Interest on these obligations issued prior to 1983 was exempt from U.S. income tax by virtue of section 3 of the Federal Relations Act. From 1983 to the present, the interest is excluded from gross income under section 103(a) of the Code. In either event, the interest is not in gross income and thus may not qualify as QPSII. Such a result is anomalous in that investment income which is not taxed by reason of the possessions tax credit is excluded from the

alternative minimum tax, but income from Puerto Rican government sources which otherwise would be eligible for the possessions tax credit but for the fact that it is already exempt, may be subject to the alternative minimum tax. Such a result would cause taxpayers to favor "taxable" investments over Puerto Rican government investments to the detriment of the Puerto Rican government and the various programs, such as housing and Caribbean Basin Initiative in which the funds would be used. In order to eliminate uncertainty, the statute should be amended to exclude from the alternative minimum tax any amount excluded from gross income under section 103(a) which would meet the requirements of section 936(d)(2) if it were not so excluded.

4. Allocation of Expenses.-- Section 1215 of the Act amends section 864 by adding a new subsection (e) dealing with the allocation of interest and other expenses. The application of these rules to Puerto Rico is unclear. The statute says that the new section 864(e) is applicable for purposes of international provisions (except as provided in regulations).

There was a Senate floor colloquy confirmed by the Chairman of the Ways and Means Committee that provides that the provision treating all members of the affiliated group as a single corporation for purposes of allocating interest expense is not to apply for purposes of section 936(h) (relating to the profit-split and cost-sharing methods of determining income from manufacturing). The colloquy is silent as to the impact of the interest rules for other provisions as well as the treatment of other expenses.

The colloquy leaves unanswered the impact of any allocation on section 936(a). If section 864(e)(1) applies, the benefit obtained by the Senate floor colloquy would be reduced. We understand that there was no intention to allocate interest expense to the manufacturing and investment income of a section 936 company. Not applying the section 864(e)(1) rules for profit-split and cost-sharing only partly achieves this goal. Those rules determine what portion of the income from the sale of the product may be earned by the section 936 company. Section 936(a) defines what income earned by a 936 company is eligible for the section 936 credit. Thus, if the interest expense were allocated to income for section 936(a) purposes, it would reduce the amount of the credit. Accordingly, confirmation is needed that section 864(e)(1) does not apply for purposes of the section 936(a) computation.

It is also not clear, for purposes of section 904 allocations, what is the treatment of either the stock in a section 936 company or the assets of a section 936 company. For purposes of the foreign tax credit limitation, a section 936 corporation is not a member of the group and the limitation is based upon foreign source income of the group over world-wide income of the group. Neither the income nor taxes of a section 936 corporation is taken into account. Even in the case of a dividend from a section 936 corporation, the dividend has no impact on the foreign tax credit, since there is a dividends received deduction equal to the amount of the dividend. However, by taking the assets and gross income of the section 936 corporation into account as part of the group or by treating the stock of a section 936 corporation as an asset with an adjusted basis, the statute could be read as requiring the consideration of these assets and income or stock in calculating the interest and other expense allocations for purposes of section 904. It is recommended that the statute clarify the fact that for purposes of section 904 calculations, the investment in the stock or the assets and income of a section 936 corporation are not taken into account.

5. Gross Income Test.-- Section 936(a)(2)(B) was amended by the Tax Reform Act to require that 75 percent of the gross income of a possessions corporation for the three-year period immediately preceding the close of its taxable year be derived from the active conduct of a trade or business within a possession. For a calender year 1987 taxpayer, the provision appears to require that for the years 1987, 1986, and 1985 that at least 75 percent of its gross income be active trade or business income. The reduction in 1987 of the amount of allowable investment income that may be earned in prior years is a retroactive change in the law that could deny the possessions tax credit to many corporations.

Prior to amendment by the Tax Reform Act, the requirement was 65 percent for 1986 and 1985, and 60 percent for 1984. Thus, in 1986 relying on the then existing provisions, a taxpayer could have had less than 65 percent of its gross income for the three preceding years from an active trade or business income. Even if a corporation was carefully following the legislative developments regarding the Tax Reform Bill, until the Senate Finance Committee acted in July of 1986, the provision in the House Bill was the relevant consideration and the House Bill would have increased the active business requirement to only 70 percent in 1986. Accordingly, if during 1986 a corporation made immediate adjustment to compensate for the change from the 70 percent requirement of the House Bill to 75 percent of the Senate Bill, it could not, in the extreme case, have complied with the new 75 percent requirement for 1987. In order to meet the 75 percent requirement in 1987, a taxpayer who had 65 percent in 1985 and 70 percent in 1986 from an active trade or business and who had not increased its gross income in 1987 would be forced to meet a requirement of having 90 percent of its gross income in 1987 from an active trade or business.

It is recommended that the effective date of the new 75 percent requirement be phased-in in a manner so that taxpayers who have made a good faith effort to satisfy the requirement not be adversely affected. It is suggested that the testing period for the new 75 percent requirement be computed on a phase-in basis by using a weighted-average based upon the applicable percentages specified in each taxable year of the testing period. For example, if a taxpayer's gross income in 1985 was $100, in 1986, was $110 and in 1987 is $125, the test would be satisfied if $230.25 (65% of $210 + 75% of $125) was active business income. It should be kept in mind in considering this proposal that what was done for 1986 is done and therefore any change to add relief from the retroactive rules impacts only to relieve companies from the disasterous consequence of complete disqualification from section 936.

Sincerely,

Carl A. Nordberg, Jr.

Carl A. Nordberg, Jr.

COMMENTS ON THE
TECHNICAL CORRECTIONS ACT OF 1987

SUBMITTED BY

REV. ROBERT F. WEISS, S.J., PRESIDENT

ROCKHURST COLLEGE, KANSAS CITY, MISSOURI

As the Congress considers the Technical Corrections Act of 1987 (H.R. 2636), I respectfully submit the following comments on three areas of last year's Tax Reform Act which need clarification: early retirement plans for faculty, tuition remission for graduate teaching and research assistants, and charitable gift annuities. The clarification of each of these items is important to students, faculty and higher education as a whole.

1. Faculty Early Retirement Plans

The Tax Reform Act does not specify that these plans are to be considered as deferred compensation. However, in January of this year, the IRS issued an interpretation which treats these plans as deferred payment. Such a broad definition has wide-ranging implications for the ability of campuses to seek voluntary termination of tenure agreements. The Technical Corrections Act should clarify that early retirement plans for faculty are not taxable as deferred compensation.

2. Tuition Remission for Graduate Assistants

The Tax Reform Act of 1986 contains two sections which seem to be in conflict. A 1984 addition to the Tax Code permitted tuition remission to be treated as a tax-free scholarship. This was continued without amendment in the 1986 Tax Reform Act. However, the Act added a new section 117(c) which makes service-connected scholarships taxable as compensation. As a result, in the same section of the Code there is a general rule which imposes taxes on service-connected scholarships and a specific rule exempting tuition remission awards. Neither the final version of the Act nor the House-Senate Conference Report explains how to read these two rules together. Including such tuition remission (sometimes called "tuition grants") in taxable income would result in significant loss of these awards through taxation. The Technical Corrections Act should make clear that tuition remission provided to graduate teaching and research assistants is completely exempt from taxation.

3. Charitable Gift Annuities

In its present form, H.R. 2636 leaves open the possibility of considering charitable gift annuities to be "commercial-type insurance" and subject to IRC Sec. 501(m). Failure to clarify the ambiguity would remove an important source of funding for charitable organizations and contradict the clear intent of the Congress.

In 1969 Congress added Tax Code section 514(c)(5) specifically to deal with treatment of charitable gift annuities. This section was not amended in the Tax Reform Act. Yet the new section 501(m) of the Tax Reform which taxes commercial insurance activities of non-profit organizations could be read to include charitable gift annuities. The Tax Reform did not include charitable remainder trusts under IRC 501(m). For less wealthy donors, a charitable gift annuity is the equivalent of a charitable remainder trust. It is clear that the Congress has intended to offer incentives to charitable giving for both small and large donors. This intent needs to be clarified.

Charitable gift annuities do not compete with commercial annuities nor are they "commercial-type insurance" activities. Moreover, subjecting those annuities to taxation under IRC 501(m) would discourage rather than promote charitable giving by less wealthy donors. The result would be the removal of a significant source of funding for charitable organizations across the board. Therefore, the Technical Corrections Act should be amended to clarify that Charitable Gift Annuities are not subject to IRC 501(m).

As the committee considers changes in the Tax Reform Act, it is important that it be aware of its effects on the various segments of our country. Thank you for the opportunity to bring some of the concerns of the higher education community to the attention of the committee.

Submitted July 8, 1987

TOM S. KING
Executive Vice President

TEXAS SAVINGS & LOAN LEAGUE • 408 W. 14TH ST. • AUSTIN, TEXAS 78701 • 512/476-6131

July 16, 1987

Mr. Robert J. Leonard
Majority Staff Director
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, D.C. 20515-6348

Dear Mr. Leonard:

In accordance with Policy release #12 of the Committee on Ways and Means, the Texas Savings and Loan League, representing 280 member associations, is submitting the comments from the California League of Savings Institutions which are presently on file with the committee.

The Texas Savings and Loan League strongly supports the position taken in the paper submitted by the California League and urges inclusion of these items in the final version of H.B. 2636 and S. 1350 (Technical Corrections Act of 1987).

Sincerely,

Tom S. King

Tom S. King
President

Tulane
Office of the Academic Vice President and Provost
327 Gibson Hall
Tulane University
New Orleans, Louisiana 70118
(504) 865-5260

July 1, 1987

Mr. Robert J. Leonard
Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Leonard:

As President of the Association of Graduate Schools of the Association of American Universities and as Provost and Dean of the Graduate School of Tulane University, I am writing in response to the invitation of the House Ways and Means Committee. This is a letter of comment on H.R. 2636, which would make technical corrections on the Tax Reform Act of 1986. I am deeply concerned about three areas: tax-free tuition remission for graduate teaching and research assistants; charitable gift annuities; and early retirement plans for faculty.

Tax-Free Tuition Remission:

The Technical Corrections bill should clarify that tuition remission (or tuition grants) provided to graduate teaching and research assistants is completely exempt from taxation.

In 1984, Congress added to the Tax Code a new section which permitted tuition remission (often called tuition grants) to be treated as a tax-free scholarship by the student recipients (section 117(d) as amended by 127(c)(8)). Although this section was continued without amendment in the Tax Reform Act, the Act added a new section 117(c) which makes service-connected scholarships taxable (in whole or in part) as compensation. Thus, in the same section of the Code is a general rule taxing service-connected awards and a specific rule exempting tuition remission awards. Neither the final version of the Act nor the House-Senate Conference Report explain how to read these two rules together. Some key Hill staff interpret the Act to require that these tuition remission awards be excluded from income only if the student receives some other form of compensation for the teaching or research services rendered. This conflicts with academic practices of integrating teaching and research activities into the degree requirements; if not changed, it will result in a significant loss of these awards through taxation.

Charitable Gift Annuities:

The Technical Corrections Act should clarify that charitable gift annuities are not subject to the unrelated business income tax because they are not commercial insurance under section 501(m).

Charitable gift annuities, through which a donor may give an immediate gift to a nonprofit organization and receive back a specified income for life, have never been treated as an unrelated trade or business. In fact, in 1969, Congress added Tax Code section 514(c)(5) specifically to direct how charitable gift annuities are to be treated under the unrelated business income tax. This section was not amended by the Tax Reform Act; however, the new section 501(m), which taxes commercial insurance activities of nonprofits, could be read to include charitable gift annuities. A clarification is needed so that this method of making charitable gifts -- which is predominately utilized by less wealthy donors -- does not subject the nonprofit recipients of these gifts to the unrelated business income tax. Failure to make this clarification will discourage the use of this important giving method.

Early Retirement Plans:

The Technical Corrections Act should clarify that early retirement plans for faculty, which in essence buy back an unlimited tenure contract, are not taxable as deferred compensation.

The Tax Reform Act imposed limitations on the deferred compensation arrangements available to employees of nonprofit organizations which paralleled limitations previously placed upon employees of public institutions (section 457). These changes impose upon new deferred compensation plans two significant restrictions: first, that eligible deferred compensation plans are limited to $7,500 per annum or 33 and 1/3 percent of compensation; and second, that such plans are considered elective contributions for tax-sheltered annuity catch-up rules. Plans which exceed this amount are treated as immediately taxable to the beneficiary.

The Act does not specify that these early retirement plans are to be considered as deferred compensation. However, in January, 1987, the IRS issued an interpretation (Notice 87-13, Jan. 26, 1987) which treats these plans as deferred compensation. This broad definition has wide-ranging implications for the ability of campuses to seek voluntary termination of tenure agreements, and should be corrected immediately.

I hope that these corrections essential to higher education will be incorporated in H.R. 2636. If you have any questions, I would be pleased to respond to the best of my ability.

Sincerely,

Francis L. Lawrence
Academic Vice President
and Provost
Dean of the Graduate School

STATEMENT OF

UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS

The U.S. League of Savings Institutions* welcomes this opportunity to publicly comment on a number of important tax issues which arose following passage of the historic Tax Reform Act of 1986. This landmark legislative revision of our individual and corporate tax laws was so comprehensive that numerous errors, mistakes and unintended consequences were understandably included in the final law. The list of errors also encompasses a number of savings institution problems. Each of these will be briefly described below followed by the reasons the savings institution business believes that including these changes in the 1986 tax reform legislation was either an oversight or a mistake and should be corrected by this Technical Corrections Act of 1987.

I. "At Risk" Rules

The 1986 Tax Act extended the "at risk" loss limitation rules to deductions resulting from the holding of real property acquired with nonrecourse financing. The "at risk" rules limit the tax benefits derived from real property investment to the investor's equity or the amount for which the investor is personally liable. An exemption was provided for nonrecourse loans secured by real property where the borrowing is from a "qualified person" (defined as "any person who is actively and regularly engaged in the business of lending money"). Thus, a qualified person would include a savings and loan or savings bank regulated under federal or state law. However, despite the qualified person definitional exception, purchasers of foreclosed real estate from depository institutions which also provide financing for the purchase remain exposed to the "at risk" restrictions.

The rules were extended to real property in the 1986 legislation to prohibit taxpayers from artificially inflating the asset's basis and thereby increasing its depreciation and capital gains tax benefits. Prior law encouraged such tax schemes through its generous accelerated cost recovery periods, particularly for real estate, and a 60 percent capital gains exemption.

The 1986 Tax Reform Act corrected this underlying rationale for "at risk" limitations by repealing the favorable ACRS depreciation schedules as well as the capital gains exclusion. Under the new 1986 rules, the cost of residential real property must be recovered no earlier than 27.5 years with most other real property recovered over 31.5 years, using the straight-line method. Additionally, the 1984 Deficit Reduction Act adopted the imputed interest rules (Section 1274) which effectively eliminated the below market interest rate as another favorite seller financing tool. All these recent tax law changes have made it virtually impossible to inflate a seller's basis and achieve unjustified tax savings. If the potential for tax law abuse has been eliminated, then why is it necessary to apply the restrictive "at risk" rules to real estate?

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* The U.S. League of Savings Institutions serves the more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: Joe C. Morris, Chairman, Emporia, Kansas; Theo H. Pitt, Vice Chairman, Rocky Mount, North Carolina; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations; Coley C. O'Brien, Senior Vice President and Legislative Counsel; Brian Smith, Senior Vice President, Regulatory Operations. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone (202) 637-8900.

The U.S. League strongly believes that the specific application of the "at risk" limitations to purchaser-borrowers of foreclosed property from regulated institutional seller-financiers is a more serious mistake and will cost thrifts far more in carrying costs and disposition expense than it could ever produce in tax revenue. In addition, thrifts are substantially limited by law, regulation and public policy to real estate financing and, therefore, the "at risk" rules are particularly harsh on these institutions. Historically, thrift institutions finance more than 80 percent of their own foreclosed properties. They do not wish to be property owners, especially owners of foreclosed property. However, by expanding the "at risk" rules to seller-financiers, it will make this situation almost unavoidable. In addition, these new "at risk" rules will be particularly prejudicial to savings and loans operating in ten states where state law prohibits lenders from making recourse loans with respect to sales of their own foreclosed properties.

The expanding "at risk" rules will also greatly aggravate the many existing difficulties already involved in disposing of foreclosed property by requiring potential purchasers to arrange financing from other lenders unfamiliar with the property. In most situations, alternative financing will be unavailable because of the nature of the underlying real estate. This result occurs in spite of the fact that the lender in most of these cases was the original qualified third party lender who became a seller-financier only because of circumstances beyond his control. Is this the kind of abusive activity that necessitates extending the restrictive "at risk" rules even to foreclosed property?

The 1986 Tax Reform Act extended the "at risk" limitations to seller financing by a qualified person while at the same time exempting nonrecourse real estate financing by a party related to the purchaser provided the financing from the related person is "commercially reasonable" and on substantially the same terms as loans involving unrelated persons. The U.S. League urges this Committee to provide a similar "commercially reasonable" exception for nonrecourse real estate financing of repossessed property by a thrift provided the following requirements are met:

1. The interest rate charged on the loan is not less than the Applicable Federal Rate (AFR).

2. The amount of the loan does not exceed the thrift's adjusted basis in the property, unless facts and circumstances warrant a higher loan value.

3. If the loan exceeds the adjusted basis, and facts and circumstances do not warrant a higher limit, the excess amount of the loan would be subject to the "at risk" limitation.

II. 1987 Tax Rate Spike for Thrifts

The statutory language adopted in the revision of the Section 593 thrift bad debt deduction interacts in an adverse and unforeseen way with the drop in the overall corporate tax rate. The reduction in the corporate rate from 46% to 34% is accomplished over two years with a 40% rate for calendar year taxpayers for 1987 and a blended rate for fiscal basis taxpayers (a taxpayer with an October 1 to September 30 tax year would have a 43% rate for its fiscal 1987 which began on October 1, 1986).

The adjustment to the allowable percentage-of-income thrift bad debt deduction from, in effect, 32% to 8% was carefully calibrated with the 34% corporate tax rate to ensure that the overall federal corporate tax rate for savings institutions remained exactly the same at 31.28% before and after tax reform.

Unfortunately, since the staggered drop in the general corporate rate to 34% is not coordinated with the January 1987 decline in the thrift bad debt percentage from 32% to 8%, calendar year savings institutions face a significant increase in their tax rate for 1987 alone: the rate is 36.8% for this one year, more than 5% higher than the 31.28% rate in effect prior to 1987 and from 1988 onwards.

The general goal of the corporate tax reform effort was to promote straightforward business operations and to reward such activities with lower rates. To impose a higher tax rate on most thrifts in 1987 is at odds with this goal and is clearly unfair and unintended. The problem can be simply corrected by providing that, for calendar year taxpayers eligible for Section 593 bad debt provisions, the 1987 percentage-of-income deduction shall be 21.8% rather than 8% as under current law. The 1987 federal tax rate would thereby remain steady at 31.28% for these institutions.

The revenue impact of this provision as estimated by the Joint Tax Committee staff is, we understand, negligible.

III. NOL Extension Denied to 1982 Fiscal Year Thrifts

The 1986 Tax Reform Act provided thrift institutions an additional three years of net operating loss carryforward benefit for NOLs incurred in taxable years beginning after December 31, 1981 and before January 1, 1986. This effective date wording unfortunately denies most of the eight-year NOL carryforward benefit to those thrifts that operate on a fiscal year basis. There are a substantial number of fiscal year thrifts that begin their taxable years before December 31, 1981 and, consequently, would lose a substantial portion (depending on their fiscal year start - October 1, 1981; July 1, 1981; April 1, 1981) of their NOL carryforward benefit for 1982 tax losses. For example, as a result of this effective date language, an October 1 fiscal year thrift would appear to be prohibited from carrying its losses from the first nine months of 1982 forward for eight years.

The intent of this NOL carryforward provision was to provide all thrifts, not just calendar year thrifts, with three additional years to carry forward the operating losses of this period. There is no justifiable reason for denying the statutory NOL extension to fiscal year thrifts and we ask that the Technical Corrections legislation resolve this discrepancy in wording by allowing fiscal year thrifts to utilize the extended eight-year NOL carryforward benefit for all NOLs sustained in 1982.

IV. The 20 Percent Deposit Continuity Test for NOL Carryovers

Under prior law (Sec. 382(b)(2)(A)), NOLs were fully preserved in a supervisory case where the acquired thrift's deposits comprised at least 20 percent of the total deposits of the acquiring institution. When the acquired thrift's deposits fell below this 20 percent continuity test, its NOLs were not lost but merely reduced or scaled down by 5 percent for each one percentage point below this 20 percent of transferred deposits threshold (Sec. 382(b)(2)(B)).

The newly-enacted Section 382(l)(5)(F) retains the former 20 percent deposit continuity test but omits the important scaledown formula when transferred deposits are less than 20 percent of total combined deposits of the acquirer. It, in effect, establishes a threshold test of 20 percent of deposit continuity with no NOL benefit scaledown when the ratio falls below 20 percent. As a result, when 20 percent deposit continuity is not maintained, the remaining NOLs become subject to the more restrictive 382 limitations. Since in most thrift supervisory cases the financially troubled thrift's value will be zero or less, no NOL carryover benefit will be available to an acquiring thrift when the deposit continuity is less than 20 percent.

This result does not appear to be the intention of either the tax writing committees or their conferees. On the contrary, the policy decision of Congress, as enunciated in the Conference Report on the Tax Reform Act of 1986, Volume II, page 193, was clearly to preserve FSLIC provisions unchanged through the end of 1988. Nevertheless, this 20 percent threshold test change was included in the statute. Indeed, this statutory change makes it more difficult to accomplish the very type of acquisition which FSLIC is attempting to encourage, namely, that large, healthy thrifts rescue smaller troubled institutions. The carryover of NOLs is an important feature in consummating this type of troubled thrift acquisition. Thus, the prior law scaledown procedure should be retained as an incentive for large thrift acquisitions of smaller troubled institutions. Loss of this procedure will exacerbate the problems already faced by FSLIC in handling the financially troubled thrift situation.

For all the foregoing reasons, the U.S. League urges Congress to restore the 20 percent deposit continuity test scaledown formula of former law (Sec. 382(b)(2)(B)) which appears to have been inadvertently eliminated from the new Sec. 382 statutory language.

V. "Firm Commitment" Underwriting

The U.S. League greatly appreciates the fine work of the Ways and Means and Joint Tax Committee staffs on the "firm commitment" problem by including the corrective language on this problem in the recently introduced Technical Corrections legislation (H.R. 2636 and S. 1350). A firm commitment underwriting, in connection with a public offering of stock in a converting mutual savings and loan association, is protected against reduction in NOL carryovers under the two-year "window" for thrift public offerings during 1987-88 (Sec. 106(d)(15) - Technical Corrections bill).

VI. FSLIC-Created "Interim Associations" Should Not Extinguish NOLs

An analogous situation to the firm commitment problem has recently been identified under the 1986 Tax Reform Act. A second reorganization occurring within two years after a first reorganization extinguishes NOL carryovers in toto for years following the second reorganization (Sec. 382(l)(5)(D)). This provision will potentially wipe out NOL carryovers in a FSLIC-supervised acquisition of an insolvent thrift where the thrift's assets are first conveyed to an "interim savings institution" created and operated by FSLIC while a buyer is sought, and then a buyer acquires control of the interim association.

Under prior law, this two-step procedure would not have affected NOL carryovers. In keeping with Congress' clearly stated policy, which is to maintain prior law through 1988, these two parts of a supervisory acquisition should not disallow important tax attributes. The U.S. League requests that the Technical Corrections legislation provide an exemption from the two-year rule for FSLIC-created "interim associations."

NON-TECHNICAL CHANGES

Reorganization of Financially Troubled Thrift Institutions

Present law provides special rules through December 31, 1988 which exempt the acquisition of financially troubled thrift institutions from rules otherwise applicable to acquisitions, mergers and the receipt of direct FSLIC financial assistance. These provisions, enacted in the Economic Recovery Tax Act of 1981, relax certain requirements for qualification as a tax-free bankruptcy reorganization under the Code. Thus, the requirements that (1) the acquired corporation undergo formal receivership or similar proceedings, and (2) the shareholders and creditors of the acquired corporation receive stock in the acquiring corporation, need not be met (Sec. 368(a)(3)(D)). Although no formal receivership or similar proceeding is required, certain certifications regarding the financial condition of the thrift institution must be received from the Federal Home Loan Bank Board.

In addition, the 1981 Act provisions relaxed the rules regarding the survival of net operating loss carryovers following a merger (Sec. 382(b)(7)), as discussed earlier, and exempted from income and basis adjustment certain payments from FSLIC to the troubled thrift (Sec. 597).

These important tax rules, enacted to broaden the assistance available from the insurance fund, were extended for only two additional years by the Tax Reform Act of 1986. If these provisions were to sunset, as now scheduled on December 31, 1988, the ability of FSLIC to adequately meet its troubled thrift caseload would be seriously impaired. Therefore, some additional extension of these favorable FSLIC tax rules must be considered if the industry is to have the resources necessary to resolve its troubled thrift caseload.

July 17, 1987

Mr. Robert Leonard
Chief Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

On behalf of Vanderbilt University, I am writing to comment on H.R. 2636, the Technical Corrections Act of 1987. Our main concern is that the bill should clarify that early retirement plans for faculty are not taxable as deferred compensation.

Early retirement plans for tenured faculty are in essence buy backs of an unlimited tenure contract. The availability of these plans is important to America's colleges and universities in a time of aging faculty populations, limited resources, and the legislated elimination of mandatory retirement. In order to make more tenured positions available for younger professors, it is necessary to keep early retirement plans available and affordable.

The Tax Reform Act imposed limitations on the deferred compensation arrangements available to employees of nonprofit organizations which paralleled limitations previously placed upon employees of public institutions (section 457). These changes impose two restrictions upon new deferred compensation plans: first, that eligible deferred compensation plans are limited to $7,500 per annum or 33 1/3 per cent of compensation; and second, that such plans are considered elective contributions for tax-sheltered annuity catch-up rules. Plans which exceed this amount are treated as immediately taxable to the beneficiary.

The Act does not specify that these early retirement plans are to be considered as deferred compensation. However, in January, 1987, the Internal Revenue Service (IRS) issued an interpretation (Notice 87-13, January 26, 1987) which treats these plans as deferred compensation. This broad definition should be corrected immediately as it has broad implications for the ability of schools like Vanderbilt to seek voluntary termination of tenure agreements.

Another issue of interest to us is the need for clarification that charitable gift annuities are not subject to the unrelated business income tax because they are not commercial insurance under section 501(m). This method of making charitable gifts, through which a donor may give an immediate gift to a nonprofit organization and receive back a specified income for life, is predominantly used by less wealthy donors.

Section 501(m) of the Tax Reform Act can be read to include charitable gift annuities, even through Congress enacted section 514(c)(5) in 1969 specifically to direct how charitable gift annuities are to be treated under the unrelated business income tax, and 514(c)(5) was not amended by the Tax Reform Act. A clarification is needed in order to give non-profits the use of this important giving method.

Thank you for the opportunity to comment. Please contact me if you or your staff needs further information.

Sincerely,

Carr

Jeff Carr
Vice Chancellor for
University Relations and
General Counsel

Title I, Section 102

Seidman & Seidman | BDO
15 Columbus Circle, New York, New York 10023 (212) 765-7500, TLX 661 903

July 14, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: 1987 Technical Corrections Bill (H.R. 2636)

Dear Mr. Leonard:

Section 102(a) of the 1986 Tax Reform Act amended Section 63 of the 1986 Internal Revenue Code to provide that, in the case of an individual for whom a personal exemption deduction is allowable on another taxpayer's return, the individual's standard deduction is limited to the greater of $500 or the individual's earned income. This limitation causes two taxpayers with the same amount of unearned income to be treated differently if one of them also has earned income.

If this unfair result is unintended, Code Section 63(c)(5) should be corrected to limit the standard deduction in this situation to the greater of--

(A) $500, or

(B) the individual's earned income plus $500. (Suggested correction underscored.)

Respectfully,
SEIDMAN & SEIDMAN/BDO

Mario P. Borini

Mario P. Borini, CPA, PhD
National Director of
Tax Practice

STUART R. JOSEPHS
6408 CRYSTALAIRE DRIVE
SAN DIEGO, CALIFORNIA 92120-3834

July 13, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: 1987 Technical Corrections Bill (H.R. 2636)

Dear Mr. Leonard:

Section 102(a) of the 1986 Tax Reform Act amended Section 63 of the 1986 Internal Revenue Code to provide that, in the case of an individual for whom a personal exemption deduction is allowable on another taxpayer's return, the individual's standard deduction is limited to the greater of $500 or the individual's earned income. This limitation causes two taxpayers with the same amount of unearned income to be treated differently if one of them also has earned income.

If this unfair result is unintended, Code Section 63(c)(5) should be corrected to limit the standard deduction in this situation to the greater of--

(A) $500, or

(B) the individual's earned income plus $500. (Suggested correction underscored.)

Respectfully,

Stuart R. Josephs

Stuart R. Josephs, CPA
(619) 469-6999

Section 123

United States Information Agency

Washington, D.C. 20547

USIA

July 9, 1987

Re: Tax Treatment of Scholarship/Fellowship Grants to Visiting Students and Scholars

Dear Mr. Leonard:

I am writing to comment on the recently introduced "Technical Corrections Act of 1987" (H.R. 2636 and S. 1350) on behalf of U.S. Government-funded international educational exchange programs, in particular the Fulbright Fellowship program.

As you know, section 101(d)(2) of the proposed legislation makes a technical amendment to section 123 of the Tax Reform Act of 1986 (the "1986 Act") relating to the tax treatment of scholarship or fellowship grants to nonresident aliens. The amendment provides that withholding at a 14-percent rate applies to amounts received by a nonresident alien who is not a degree candidate as a scholarship or fellowship for study, training or research at a U.S. educational institution if the grant is made by a qualified grantor. Such qualified grantors include the U.S. government, Fulbright Commissions and foreign governments. We are relieved that the Committee has recognized the need for this correction and included it in the proposed legislation.

This correction is essential to avoid the imposition of the 30-percent withholding rate on such amounts. It is also necessary to ensure that such amounts will continue to be subject to tax on a net income basis at the regular graduated tax rates. Under provisions contained in the 1986 Act, withholding at a 14 percent rate and taxation on a net basis would apply only to amounts which are received by a degree candidate and incident to a qualified scholarship.

Mr. Robert Leonard, Chief Counsel
Committee on Ways and Means
House of Representatives

While we applaud the bill's extension of the 14-percent withholding rate to foreign students, trainees and research fellows who are not candidates for a degree, we would like to bring to your attention the failure of the proposed correction to extend that lower rate to another important category of international exchange scholar--i.e., visiting lecturers (and exchange teachers). When Congress in 1961 amended section 1441(b) of the tax code to provide a reduced rate of withholding for visiting scholarship/fellowship recipients, its explicit purpose was "to relieve foreign students, teachers and scholars of certain requirements which have the effect of reducing the value of their stipends while they are in this country." Conf. Rep. No. 1197, 87th Cong., 1st Sess. (1961), as reprinted in 1961 U.S. Code Cong. and Ad. News at 2781. The explicit inclusion of visiting lecturers in section 101(d)(2) of the technical corrections bill is therefore essential to give effect to this stated purpose.

Extending the 14-percent withholding rate to visiting lecturers is also necessary to prevent significant overwithholding of tax. Because Fulbright lecturers and exchange teachers are ultimately subject to tax at the regular graduated rates on a net basis, withholding at a flat 30-percent would result in a gross amount of overwithholding. Such fellowships are designed to cover only the recipient's basic living expenses in the United States, the greater part of which are ultimately deductible. Distributing large refunds long after the funds are needed to cover living expenses provides no relief for the visiting scholars during their stay in the United States and results in an outflow of dollars from this country to scholars who have returned to their own countries at the end of their grant periods.

The amendment extending the 14-percent rate to visiting lecturers and teachers is also necessary to equalize the tax treatment of foreign lecturers sponsored by the Fulbright Program or other governmental grantors with those who are hired directly by the institutions in which they are placed. Foreign lecturers who are employed directly by a U.S. university are subject to withholding on their income as wages. Wage withholding is imposed at the graduated rate and replaces, where applicable, the flat 30-percent withholding rate normally imposed on compensation paid to a non-resident alien. By contrast, foreign lecturers who are funded by a grant do not qualify for wage withholding because of the absence of an employer-employee relationship. As U.S. Government sponsored scholars, Fulbright Program grantees should be treated at least as favorably as foreign lecturers who are employees of U.S. educational institutions.

Further, a more realistic withholding rate is essential to preserve U.S. Government-sponsored programs. If grants to foreign visiting lecturers and exchange scholars remain subject to a 30-percent withholding liability, U.S. Government grantors, such as the U.S. Information Agency, will have to increase the size of their grants dramatically, reducing the number of awards made and resulting in an inefficient use of U.S. Government program funds. The result would be fewer participants and the distribution of tax refunds to grantees abroad after they had left the United States. Similarly, imposing excessive withholding on programs which are financed by foreign governments but administered by U.S. nonprofit agencies under the Fulbright umbrella will discourage foreign cooperation and also result in a drastic reduction in the number of visiting lecturers and exchange scholars coming to the United States with non-U.S. Government funding.

In the final analysis, the imposition of excessive withholding obligations on grants to foreign students and scholars will have extremely negative consequences on American public diplomacy. Neither foreign students and scholars nor foreign grantors can easily accept the fact that the withholding tax burden imposed on them will be significantly greater than that imposed in U.S. students and scholars. These terms have already provoked strong protest from foreign governments. Under current law, as amended by the 1986 Act, U.S. students and scholars are subject to withholding only if their grants represent compensation for services required by the granting institution, and then only at the graduated wage withholding rates. Because their grants are not compensatory in nature, U.S. Fulbright scholars will not be subject to withholding or reporting requirements. By contrast, foreign Fulbright scholars will be subject to withholding at a minimum rate of 14 percent. Without the technical correction described above, such scholars will have taxes withheld from their grants at a flat 30 percent rate. It is clear that a withholding tax burden of this magnitude not only discourages foreign governments from assisting in funding our international exchange programs, but also invites them to retaliate by amending their tax codes to impose greater burdens on U.S. students and scholars abroad.

In sum, the imposition of excessive withholding upon foreign students and scholars will impair the effectiveness of U.S. Government-funded programs and undermine the international agreements upon which these educational exchanges are based. The importance of preserving international exchange programs, such as the internationally respected Fulbright program, can hardly be overstated. Reducing the withholding rate to a realistic level, as the proposed tech correction would provide, would contribute to the health and stability of these vital programs.

I have enclosed materials prepared by Patton, Boggs and Blow at the request of one of the cooperating private institutions engaged in implementation of the Fulbright Program, the Council for International Exchange of Scholars, which suggest a rationale and statutory language for extending the 14 percent withholding rate to visiting foreign lecturers and teachers.

I would appreciate your consideration of this proposed change in the "Technical Corrections Act of 1987." I would, of course, be pleased to respond to any questions you may have regarding the history and impact of taxation and withholding from U.S. Government funded and foreign government funded Fulbright educational exchange program grants administered by the United States Information Agency, and to provide any further detail you may require regarding the importance of the proposed technical correction to the integrity of our programs.

Sincerely,

Mark Blitz

Mark Blitz
Associate Director
Bureau of Educational
and Cultural Affairs

Enclosures:
- a) Proposed Amendment to Technical Correction to Section 123 (b) of the Tax Reform Act of 1986
- b) Exhibit A--Draft Statutory Language
- c) Exhibit B--Differential Taxation of U.S. and Foreign Exchange Lecturers and Teacher (numerical example)

ENCLOSURE

PATTON, BOGGS & BLOW

June 8, 1987

Proposed Amendment to Technical Correction to Section 123(b) of the Tax Reform Act of 1986

Purpose of the Proposed Amendment

To extend the lower 14% withholding rate under section 1441(b) of the Code to foreign exchange lecturers who are recipients of fellowship grants.

Background

When in 1961 Congress amended section 1441(b) to provide a reduced rate of withholding for scholarship/fellowship recipients, it expressly intended "to relieve foreign students, teachers and scholars of certain requirements which have the effect of reducing the value of their stipends while they are in this country." Conf. Rep. No. 1197, 87th Cong., 1st Sess. (1961), *as reprinted in* 1961 U.S. Code Cong. and Ad. News at 2781 (copy attached).

However, in that same year, the Internal Revenue Service ruled that Fulbright fellowships for lecturing or teaching abroad did not constitute excludable fellowships under section 117(b)(2)(B). Rev. Rul. 61-65, 1961-1 C.B. 17. One logical result of this ruling was to remove foreign exchange lecturers from eligibility for the lower 14% withholding rate, which under prior law was premised on the scholar's grant qualifying for at least a partial exclusion under section 117. Thus, foreign exchange lecturers and teachers were (and still are) subject to a 30% withholding rate under section 1441. By virtue of a subsequent amendment to section 864(b) of the Code, they are ultimately subject to tax on a net basis at the regular graduated rates.*/

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*/ Section 102(c) of the Foreign Investors Tax Act of 1966 amended section 864 of the Code to provide that an individual performing personal services in the United States will be considered as engaged in a trade or business within the United States. Under section 871(b), the effectively connected income of a nonresident alien individual who is engaged in a trade or business in the United States is taxable at the graduated rates of tax.

Rationale for Proposed Amendment

The technical correction preserving the 14% withholding rate for students, trainees and research fellows should be extended to foreign teaching fellows for the following reasons:

- To prevent significant overwithholding of tax. Since foreign teaching fellows are ultimately subject to tax at the regular graduated rates on a net basis, withholding at a flat 30% rate will result in a gross amount of overwithholding. Teaching fellowships, unlike regular faculty appointments, provide the recipient with only a modest stipend to cover the individual's living expenses here in the United States. The fact that virtually all such expenses are ultimately deductible, thus entitling the visiting scholar to a large tax refund after he has returned home, is of little consolation. The attached numerical example illustrates this point using figures drawn from the Fulbright educational exchange program.

- To equalize the tax burdens imposed on foreign and U.S. exchange lecturers. U.S. lecturers going abroad on a grant from the U.S. government apparently are not subject to any withholding of U.S. tax. Even if such compensation were treated as wages subject to withholding under section 3402(a), they would still be significantly better off than foreign lecturers coming here. They could adjust their withholding to reflect the amount of their anticipated deductions, thus resulting in a relatively small reduction in the value of their stipends. The attached numerical example illustrates the differential tax burdens imposed on foreign and U.S. scholars.

- To preserve U.S. government-sponsored academic exchange programs. If grants to foreign exchange lecturers and teachers remain subject to a 30% withholding liability, U.S. government grantors, such as the U.S. Information Agency, and other nonprofit U.S. grantors, will have to increase the size of their grants -- at least for fellowship recipients from nontreaty countries. Such measures will necessarily result in a reduction in the overall number of grants awarded. Overwithholding not only promotes an inefficient use of U.S. government program funds but also makes educational exchange programs more difficult to administer. To the extent that excessive withholding is imposed on foreign government-funded programs (which generally are administered by U.S. nonprofit agencies), it will discourage foreign cooperation and may ultimately lead to a drastic reduction in the number of foreign exchange scholars coming to the United States.

Mechanics of Proposed Amendment.

Amend the proposed technical correction to add the phrase "teaching or lecturing" to the list of academic activities in the United States to which the 14% withholding rate would be applicable. Delete the words "as a scholarship or fellowship" so that any amount granted to an F-, J- or M- visaholder by a 501(c)(3) organization, the U.S. government, a foreign government, an international organization or commission for study, training, research, lecturing or teaching in the United States would qualify for the 14% rate. A copy of the proposed statutory language, redlined to indicate the amendment, is attached.

Exhibit A
Draft Statutory Lanuage

The second sentence of section 1441(b) is amended to read as follows:

"The items of income referred to in subsection (a) from which tax shall be deducted and witheld at a rate of 14 percent are amounts which are received by a nonresident alien who is temporarily present in the United States as a nonimmigrant under subparagraph (F), (J) or (M) of section 101(a)(15) of the Immigration and Nationality Act and which are --

(1) incident to a qualified scholarship to which section 117(a) applies, but only to the extent includible in gross income; or

(2) in the case of an individual who is not a candidate for a degree at an educational organization described in 170(b)(1)(A)(ii), granted by --

(A) an organization described in section 501(c)(3) which is exempt from tax under section 501(a),

(B) a foreign government,

(C) an international organization, or a binational or multinational educational and cultural foundation or commission created or continued pursuant to the Mutual Educational and Cultural Exchange Act of 1961, or

(D) the United States, or an instrumentality or agency thereof, or a State, or a possession of the United States, or any political subdivision thereof, or the District of Columbia,

~~as a scholarship or fellowship~~ for study, training, research, lecturing or teaching in the United States."

Exhibit B

Differential Taxation of U.S. and Foreign Exchange Lecturers and Teachers

For purposes of the numerical examples presented below, the following assumptions apply:

Grant Amount:	$22,000
Taxpayer Status:	Married, 1 dependent
Deductible Expenses:	$10,000
Other income:	0

The foreign scholar is a J visaholder and a nonresident alien for U.S. tax purposes. The grant is a 10-month exchange lectureship awarded by the U.S. government. Under the terms of the grant, the scholar may not remain in the host country for longer than 2 years. Prior to receiving the grant, both the foreign and the U.S. scholar held faculty positions in their home country to which they plan to return.

	Foreign Scholar	U.S. Scholar
Amount Includible in Income:	$22,000	$22,000
Personal Exemptions:	$ 1,900	$ 5,700
Deductions:	$10,000	$10,000
Taxable Income:	$10,100	$ 6,300
Withheld Tax:		
(at 30% rate)	$ 6,030	
(at graduated rates)		$ 1,191
Ultimate Tax Liability:	$ 1,395	$ 825
Refund (amount overwithheld):	$ 4,635	$ 366

Joint Committee on Taxation, Description of the
Technical Corrections Act of 1987 (H.R. 2636 an
S. 1350), Joint Committee Print (June 15, 1987)

individual who may be claimed as a dependent on her daughter's tax return must file a return for 1987 only if the elderly individual either (1) has total gross income exceeding $3,750 or (2) has nonearned income exceeding $1,250.

4. Rule for inflation adjustments to earned income credit (sec. 101(c) of the bill, sec. 111 of the Reform Act, and sec. 32(i) of the Code)

Present Law

The Act modifies the earned income credit to provide for inflation adjustments. An inflation adjustment to the earned income credit is rounded to the nearest multiple of $10 (sec. 32(i)(3)).

Explanation of Provision

Under the bill, the provision relating to rounding of inflation adjustments to the earned income credit applies to the sum of the earned income credit amount (prior to adjustment) plus the inflation adjustment, rather than to the inflation adjustment amount itself. Thus, the statute provides that the dollar amount of the earned income credit after being increased by the inflation adjustment is rounded to the nearest multiple of $10.

5. Cross-references to scholarship exclusion provisions in private foundation rules (sec. 101(d)(1) of the bill, sec. 123 of the Reform Act, and secs. 4945(g)(1) and 4941(d)(2)(G) of the Code)

Present Law

Code section 4945(g)(1) provides that certain scholarship or fellowship grants that are made by private foundations do not constitute taxable expenditures if the grant "is subject to the provisions of section 117(a)." Section 4941(d)(2)(G) provides that certain scholarship or fellowship grants that are made by private foundations to government officials do not constitute acts of self-dealing if the grants "are subject to the provisions of section 117(a)." The Act limits the section 117(a) exclusion for certain scholarship and fellowship grants made to degree candidates to amounts not exceeding the recipient's tuition and course-related expenses, and repeals the prior-law limited exclusion for nondegree candidates.

Explanation of Provision

The bill amends the cross-references in the private foundation provisions cited above to refer to certain scholarship or fellowship grants that would be subject to the provisions of Code section 117(a) as in effect prior to its amendment by the Act. Accordingly, the amendments made by the Act to the section 117(a) exclusion do not treat scholarship or fellowship grants made by a private foundation that would not have triggered section 4945 or 4941 excise taxes under prior law as taxable expenditures or self-dealing acts merely because such grants exceed the amount excludable by degree candidates under section 117 as amended by the Act or merely because such grants (up to the amount excludable under prior law) are made to nondegree candidates.

6. Treatment of certain scholarship or fellowship grants to nonresident aliens (sec. 101(d)(2) of the bill, sec. 123 of the Reform Act, and secs. 1441(b) and 871(c) of the Code)

Present Law

Under present and prior law, Code section 1441(b) provides for a 14-percent withholding rate on amounts received by a nonresident alien who is temporarily present in the United States under an "F" or "J" visa that are "incident to a qualified scholarship to which section 117(a) applies, but only to the extent such amounts are includible in gross income." Under section 871(c), such amounts are subject to U.S. tax on a net income basis.

Under prior law, a nondegree candidate could exclude from gross income under section 117 a limited amount of a scholarship or fellowship granted by an educational institution or other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. The prior-law exclusion for a nondegree candidate in any one year could not exceed $300 times the number of months in the year for which the recipient received scholarship or fellowship grant amounts, and no further exclusion was allowed after the nondegree candidate had claimed exclusions for a total of 36 months (i.e., a maximum lifetime exclusion of $10,800). However, this dollar limitation did not apply to that portion of the scholarship or fellowship received by the nondegree candidate for travel, research, clerical help, or equipment.

The Act repeals the limited prior-law exclusion under section 117 for grants received by nondegree candidates. As a result, scholarship or fellowship grants received by nonresident aliens who are nondegree candidates are subject to withholding at a 30-percent rate, and to U.S. tax on a gross income basis, since no amount of such grants is "incident to a qualified scholarship to which section 117(a) applies."

The Act also provides that in the case of a scholarship or fellowship grant received by a degree candidate, an exclusion under section 117 is available only to the extent the individual establishes, in accordance with the conditions of the grant, that the grant was used for (1) tuition and fees required for enrollment or attendance of the student at an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)), and (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution.

Explanation of Provision

The bill provides that withholding at a 14-percent rate applies to amounts received as a scholarship or fellowship for study, training, or research at an educational institution (described in sec. 170(b)(1)(A)(ii)) in the United States by a nonresident alien who is not a degree candidate, if the grant is made by the educational institution or any other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. Also, such amounts eligible for the 14-percent withholding rate are subject to U.S. tax on a net income basis under section 871(c).

As under present law, withholding at 14 percent and taxation on a net income basis apply to amounts received by a nonresident alien who is a degree candidate that are incident to a qualified scholarship or fellowship to which section 117(a) applies, but only to the extent includible in gross income (e.g., amounts received for room, board, or travel).

The bill applies the above rules to "M" visa holders as well as "F" and "J" visa holders.[1]

7. Coordination of two-percent floor and certain other deduction limitation provisions (sec. 101(f)(1) of the bill, sec. 132 of the Reform Act, and sec. 67 of the Code)

Present Law

Code section 67 provides that miscellaneous itemized deductions (generally, certain unreimbursed employee business expenses and certain items allowable under sec. 212) are deductible by itemizers only to the extent that, in the aggregate, they exceed two percent of the taxpayer's adjusted gross income (AGI). Other limitations also apply to particular items that constitute miscellaneous itemized deductions. For example, the last sentence of section 162(a) limits certain deductions for away-from-home living expenses incurred by Members of Congress to $3,000 per year.

Explanation of Provision

The bill clarifies that the two-percent floor on miscellaneous itemized deductions applies prior to application of the $3,000 limitation on certain deductions for Members' away-from-home living expenses. Thus, for example, a Member with AGI of $100,000 who has $5,000 of away-from-home living expense deductions described in section 162(a) (disregarding the dollar limitation contained therein) would be allowed such deductions in the amount of $3,000.[2]

This clarification is consistent with the general rule under the Act to apply certain deduction limitation provisions in the following order: first, provisions disallowing a percentage of a deduction (e.g., sec. 274(n), generally limiting meal and entertainment deductions to 80 percent of the amount otherwise allowable); second, protiple of $5, such dollar amount shall be increased to the next higher multiple of $10)."

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[1] Similar amendments relating to "M" visa holders are made to Code secs. 3121(b)(19), 3231(e), 3306(c)(19), and 7701(b)(5)(D), and sec. 210(a)(19) of the Social Security Act.

[2] In addition, if a Member has expenses subject to the $3,000 limitation and other miscellaneous itemized deductions, the amounts disallowed by the two-percent floor are disallowed proportionately. For example, assume that a Member with AGI of $100,000 has $5,000 of away-from-home expenses (qualifying for the deduction, disregarding application of the $3,000 limit and the two-percent floor, but after application of the 80-percent rule for meal and entertainment expenses) and $5,000 of other miscellaneous itemized deductions, for a total of $10,000 of potential deductions subject to the two-percent floor. Application of the two-percent floor would limit these deductions to $8,000, and the amount disallowed because of the two-percent floor would be disallowed proportionately. Thus, after application of the two-percent floor, the Member could deduct $4,000 of the away-from-home expenses and $4,000 of the miscellaneous itemized deductions. The former amount (i.e., the away-from-home expenses) is further limited to $3,000 because of the special limitation on deducting Members's expenses in sec. 162(a). Thus, the Member could deduct a total of $7,000 of miscellaneous itemized deductions.

(d) AMENDMENTS RELATED TO SECTION 123 OF THE REFORM ACT.—

(1)(A) Clause (ii) of section 4941(d)(2)(G) of the 1986 Code is amended to read as follows:

"(ii) scholarships and fellowship grants which would be subject to the provisions of section 117(a) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) and are to be used for study at an educational organization described in section 170(b)(1)(A)(ii),".

(B) Paragraph (1) of section 4945(g) of the 1986 Code is amended to read as follows:

"(1) the grant constitutes a scholarship or fellowship grant which would be subject to the provisions of section 117(a) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) and is to be used for study at an educational organization described in section 170(b)(1)(A)(ii),".

(2)(A) The second sentence of section 1441(b) of the 1986 Code is amended to read as follows: "The items of income referred to in subsection (a) from which tax shall be deducted and withheld at the rate of

14 percent are amounts which are received by a nonresident alien individual who is temporarily present in the United States as a nonimmigrant under subparagraph (F), (J), or (M) of section 101(a)(15) of the Immigration and Nationality Act and which are—

"(1) incident to a qualified scholarship to which section 117(a) applies, but only to the extent includible in gross income; or

"(2) in the case of an individual who is not a candidate for a degree at an educational organization described in 170(b)(1)(A)(ii), granted by—

"(A) an organization described in section 501(c)(3) which is exempt from tax under section 501(a),

"(B) a foreign government,

"(C) an international organization, or a binational or multinational educational and cultural foundation or commission created or continued pursuant to the Mutual Educational and Cultural Exchange Act of 1961, or

"(D) the United States, or an instrumentality or agency thereof, or a State, or a possession of the United States, or any political subdivision thereof, or the District of Columbia, as a scholarship or fellowship for study, training, or research in the United States."

(B) Subsection (c) of section 871 of the 1986 Code is amended—

(i) by striking out "section 1441(b)(1) or (2)" and inserting in lieu thereof "the second sentence of section 1441(b)"; and

(ii) by striking out "(F) or (J)" each place it appears and inserting in lieu thereof "(F), (J), or (M)".

(C) The following provisions of the 1986 Code are each amended by striking out "(F) or (J)" each place it appears and inserting in lieu thereof "(F), (J), or (M)":

(i) Section 3121(b)(19).

(ii) Section 3231(e).

(iii) Section 3306(c)(19).

(D) Clause (i)(I) of section 7701(b)(5)(D) of the 1986 Code is amended by striking out "subparagraph (F)" and inserting in lieu thereof "subparagraph (F) or (M)".

(E) Section 210(a)(19) of the Social Security Act is amended by striking out "(F) or (J)" each place it appears and inserting in lieu thereof "(F), (J), or (M)".

(e) AMENDMENT RELATED TO SECTION 131 OF THE REFORM ACT.—Subsection (f) of section 86 of the 1986

AMIDEAST
EDUCATION AND TRAINING FOR MIDDLE EAST DEVELOPMENT

July 8, 1987

Robert J. Leonard, Chief Tax Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing to comment on the new tax law's extension of tax liability to foreign students. My organization has provided information, counseling and orientation to Middle Eastern students coming to the U.S. for 35 years and has administered tens of thousands of student scholarship programs during that period. We are currently administering approximately 1800 students, some funded by the U.S. government and some funded by foreign governments, institutions and companies.

Realizing that you don't have time to read detailed presentations and that you are already familiar with the problems the new law is creating for foreign students, trainees and for their sponsors and administering agencies, I will only list briefly the reasons why my organization believes that the Congress should repeal the provisions which extend income tax liability to foreign students and trainees who are not employed or performing work for pay during their period of study in the U.S.

(1) It is already evident that this provision will not create revenue in excess of what it will cost to administer. U.S. Government-funded programs are adding the tax to their stipends in some cases and will be paying excessive administrative expense to support a complex accounting and reporting mechanism. Government contractors which administer programs must add staff and overhead expense to the administrative budgets of their programs.

(2) The withholding process is unworkable for student grantees, since their maintenance stipend is based on actual cost of living and recent information indicates that most foreign students are living below what we call the "poverty level". It is extremely difficult to explain either the taxing of students or the U.S. practice of withholding to persons from another culture.

(3) The filing of an income-tax form cannot be delegated to sponsors of students or administering agencies, which would be unwilling to accept such financial responsibility. Nor can Foreign Student Advisers or administrators be expected to provide instruction or tax advice. Thus students, who are often deficient in the English language and always deficient in understanding American regulations and bureaucracy, will be required to seek professional tax advice which only a small minority could possibly afford.

America-Mideast Educational & Training Services, Inc.
1100 17th Street, N.W. • Washington, D.C. 20036 • (202) 785-0022 • Telex 440160 • Cable: Amideast
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(4) Enforcement of the provision is either unacceptably expensive or actually impossible. Consider: There is presently no passport or immigration control of foreigners when they leave the country. Thus a new control mechanism would have to be created in order to assure compliance or confirm that the student has filed, unless airline check-in personnel can be delegated this enforcement role. Many students spend less than one year in the U.S. When they return, no address is on record where they can be reached except in few instances. How will IRS communicate with them if there are questions, incomplete information provided or an audit? How will refunds be handled--through already-overburdened U.S. consulates? Who will handle the inevitable requests for explanation, interpretation, or redress? How will a student be able to handle the possibility that he must return the refund to his sponsor...or even to the U.S. government?

(5) How does a foreign sponsor of students in the U.S. access this problem? Who instructs them about the provisions and guides their compliance. It is virtually impossible to explain, let alone justify, the strange IRS ruling that "source of funds" actually means where the money is expended. My organization has a number of foreign-sponsored scholarship programs. Some are funded by U.S. or local companies, some by foreign universities granting scholarships to outstanding students, some by important persons or heads of government and some by foreign governmen ministries. I would predict that most of these will withdraw their students rather than to pay income taxes to the U.S. government from their grants. I would further predict that many foreign governments will reciprocate with taxation of U.S. scholars in their countries

(6) My organization has representation in eight Middle Eastern countries where we are already trying to explain to sponsors that the U.S. has decided that it must tax foreign students to address its deficit problem. Our estimate is that the nature of all of the scholarship programs will be revised over the next year in order to qualify them for exemption. These revisions will leave the students largely unsupported and unmanaged in their U.S. programs and will result in a less productive U.S. educational experience.

(7) The negative impact of this decision to tax foreign student grants is already being felt in discussions here and overseas. Since the provision is both unworkable, probably unenforcable and will not produce revenue, it is being ridiculed. But, more importantly, it is strongly resented and is an indication of what is seen abroad as increasing isolationism and unwillingness to keep the doors open to intercultural and educational exchange. Those of us who are involved deeply in international exchanges believe that the damage this will do to the U.S. image in educational and cultural circles abroad is very serious and that it will contribute to the general eroding of the U.S. image as a leader in educational exchange. An unhappy event to mark the 40th Anniversary of the Fulbright program.

The above are only some of the factors that make this piece of legislation so unnecessarily disastrous. You will note that I have not addressed the Technical Corrections that have been developed by hard-working staff over the past months. This is because I am convinced that the corrections will leave the major negative impact unaddressed and the problems largely unsolved. It is my strong appeal that the answer to this problem is simply a repeal of this unworkable and value-less provision of the new tax law.

Sincerely,

Orin D. Parker
President

American Council of Learned Societies
228 East 45th Street, New York, NY 10017-3398
212 697 1505

ACLS

Stanley N. Katz
President

June 30, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1987 --
Tax Treatment of Scholarship/Fellowship
Grants to Visiting Students and Scholars

Dear Mr. Leonard:

I am writing to you with respect to the bill currently before your Committee (H.R. 2636 and S. 1350) which makes a technical amendment to section 123 of the Tax Reform Act of 1986 relating to the tax treatment of scholarship/fellowship grants to nonresident aliens.

This organization (ACLS) has legal and fiduciary responsibility for both the International Research and Exchanges Board (IREX) and the Council for International Exchange of Scholars (CIES) which administer, respectively, exchanges with the Soviet Union/East Europe and the Senior Fulbright program. As such, we are deeply concerned with the administration of federal academic exchange programs and were distressed by the requirement of section 123 of the 1986 Act which required withholding at the 30% rate for all non-degree scholarship/fellowship grants. The technical amendment reducing that rate to 14% is greatly appreciated and strongly endorsed by the private agencies cooperating with the United States Information Service in the administration of our federal exchange programs.

Imposition of the higher rate of withholding would work a serious hardship on foreign fellowship/scholarship holders and it would certainly serve as a disincentive to foreign governments who cooperate with us in these mutual exchange programs.

We at ACLS strongly endorse section 101 (d) (2) of the Technical Corrections Act of 1987, and wish to urge its passage. We concur, by the way, with the judgment of Dr. Mark Blitz of USIA that a further extension of the reduced rate to visiting lecturers and exchange teachers would be desirable. Dr. Blitz is correct in arguing that this has been the long-range intent of Congress with respect to the exchange programs. Nevertheless, we are grateful for the current amendment, and wish you to know of our support for it.

Yours sincerely,

Stanley N. Katz

STATEMENT OF THE COUNCIL FOR INTERNATIONAL EXCHANGE OF SCHOLARS TO THE COMMITTEE ON WAYS AND MEANS IN SUPPORT OF THE TECHNICAL CORRECTIONS ACT OF 1987

Re: Tax Treatment of Scholarship/Fellowship Grants to Visiting Students and Scholars

The Council for International Exchange of Scholars (CIES) is a private, nonprofit organization that works in close cooperation with the United States Information Agency (USIA) in administering the Fulbright Scholar program. In the academic year 1986-87, CIES administered approximately 1,010 grants to American scholars abroad and 990 grants to visiting scholars in the United States. Grants to visiting scholars included approximately 800 research fellowships and 190 teaching fellowships.

CIES has a particularly strong interest in the passage of the proposed Technical Corrections Act of 1987 (H.R. 2636). The proposed legislation contains a provision (section 101(d)(2) of the bill) relating to the tax treatment of scholarship and fellowship grants to nonresident aliens (amending section 123 of the Tax Reform Act of 1986 (the "1986 Act")). If this provision is not enacted, CIES will have to withhold tax from the grants it disburses to senior Fulbright scholars at a flat 30% rate. In our view, withholding of tax at that rate is clearly excessive. While the amount of net revenues at stake is insignificant, it would cause serious individual hardship to the visiting scholars and widespread damage to our international exchange programs.

In commenting on H.R. 2636, CIES has two major concerns: (1) to express our appreciation to the staff working on technical corrections for the inclusion of that provision in the proposed legislation and thus to urge its approval by the Ways and Means Committee in the mark-up process; and (2) to propose for the Committee's consideration one minor, substantive amendment to section 101(d)(2) which would have the effect of reducing the rate of withholding on fellowships awarded to visiting lecturers from 30% to 14% under section 1441 of the Internal Revenue Code (the "Code").

I. Section 101(d)(2) of H.R. 2636

Section 101(d)(2) amends section 123 of the 1986 Act by providing that scholarship or fellowship grants to certain nonresident alien individuals (F-, J-, or M- visaholders) for study, research or training in the United States would qualify for the lower 14% withholding rate under section 1441 of the Code, even though such individuals are not candidates for a degree. Otherwise, such amounts would be subject to the 30% rate generally applicable to items of U.S.-source income paid to nonresidents. In the case of nondegree candidates, availability of the 14% rate would be limited to those who qualified for the lower rate under prior law -- i.e., those receiving grants from an educational institution or other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations (including binational or multinational Fulbright commissions), or a Federal, state or local government agency.

In repealing the partial exclusion from income formerly available to grants to nondegree candidates under old section 117(b)(2), the 1986 Act inadvertently made such grants subject not only to a 30% withholding rate but also to taxation on a gross basis. Since there is no evidence that Congress, in making such grants fully includible in income, intended to increase the applicable rate of withholding or basis of taxation, a technical correction to the 1986 Act is clearly appropriate and urgently needed. In light of the potential detriment to the Fulbright program, CIES is relieved that the Committee staff recognized the need for a technical correction in this area and included it in the proposed legislation. Accordingly, CIES urges the House Ways and Means Committee to adopt the proposed correction in its markup of H.R. 2636, subject only to the one minor amendment outlined below and described in the attached June 8, 1987 memorandum.

II. A Proposed Amendment to Section 101(d)(2) of H.R. 2636

At the time CIES and other concerned organizations urged the staff of the Congressional committees to consider a technical correction extending the 14% withholding rate to nondegree candidates' grants, we were not aware that Fulbright grants to visiting lecturers would be subject to a 30% rate if not covered under the proposed correction.1/ Because visiting lecturers who are funded directly by sponsoring educational institutions generally have tax withheld from their income as wages, we assumed that Fulbright visiting lecturers would also be subject to graduated wage withholding under section 3402, a provision which, where applicable, takes precedence over withholding at a flat rate under section 1441. However, upon closer examination, it became apparent to us that Fulbright visiting lecturers probably do not qualify for wage withholding because of the lack of an employer-employee relationship. Thus, they appear to be subject to withholding on their gross income at the flat 30% rate, even though by virtue of sections 864 and 871(b), their fellowship income is ultimately subject to tax at the regular graduated rates on a net income basis.

The attached memorandum (which has previously been provided by our counsel to the staff of the Committee) sets forth several reasons why grants to nonresident alien individuals to teach or lecture in the United States should be included in the proposed technical correction preserving the 14% withholding rate for other nondegree grants: (1) to prevent significant overwithholding of tax; (2) to equalize the tax burdens imposed on foreign and U.S. Fulbright lecturers; and (3) to preserve government-sponsored academic exchange programs at their current

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1/ The proposed correction was actively supported by a number of groups and agencies involved in international educational exchange, including the National Association for Foreign Student Affairs, the Kellogg Foundation and the U.S. Information Agency.

funding levels.[2] In addition, there appears to be no tax policy justification for subjecting visiting teaching fellows to an excessive rate of withholding, while providing a reduced rate for visiting scholars engaged in research or other academic pursuits.

In closing, we would like to draw your attention to the fact there is very little, if any, net tax revenue at stake here. First of all, the numbers of affected individuals is extremely small. The Fulbright Scholar Program, as administered by CIES, is the major U.S. grantor of university-level teaching fellowships awarded to foreign individuals. It awards only 150 full teaching fellowships each year. Of that amount, at least half are completely exempt from withholding because the recipient is a resident of a tax treaty country. Second, foreign individuals who are funded directly by U.S. educational institutions will continue to be subject to wage withholding, whether or not the proposed amendment is accepted. Third, since visiting lecturers are ultimately subject to tax at the regular graduated rates, passage of the amendment would simply reduce the amount of overwithholding that would otherwise occur. We hope that the Committee will not view the U.S. Government's need for increased tax revenues as justifying the imposition of an interest-free loan to the Government on grants awarded to foreign visiting lecturers under the Fulbright program.

Cassandra A. Pyle, Executive Director,

Council for International Exchange of Scholars

John Jonas, Esq.
Kathleen M. Nilles, Esq.

Patton, Boggs & Blow

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[2] While our focus in these comments is restricted to provisions presently contained in the introduced technical corrections bill, we believe that the 1986 Act's imposition of excessive tax and withholding burdens upon foreign students and scholars needs ultimately to be addressed by much broader legislative proposals. To that end, we intend to work with the Liaison Group for International Educational Exchange in developing a legislative package to equalize the taxation of foreign scholars and U.S. scholars.

EXHIBIT I

June 8, 1987

Proposed Amendment to Technical Correction to Section 123(b) of the Tax Reform Act of 1986

Purpose of the Proposed Amendment

To extend the lower 14% withholding rate under section 1441(b) of the Code to foreign exchange lecturers who are recipients of fellowship grants.

Background

When in 1961 Congress amended section 1441(b) to provide a reduced rate of withholding for scholarship/fellowship recipients, it expressly intended "to relieve foreign students, teachers and scholars of certain requirements which have the effect of reducing the value of their stipends while they are in this country." Conf. Rep. No. 1197, 87th Cong., 1st Sess. (1961), *as reprinted in* 1961 U.S. Code Cong. and Ad. News at 2781 (copy attached).

However, in that same year, the Internal Revenue Service ruled that Fulbright fellowships for lecturing or teaching abroad did not constitute excludable fellowships under section 117(b)(2)(B). Rev. Rul. 61-65, 1961-1 C.B. 17. One logical result of this ruling was to remove foreign exchange lecturers from eligibility for the lower 14% withholding rate, which under prior law was premised on the scholar's grant qualifying for at least a partial exclusion under section 117. Thus, foreign exchange lecturers and teachers were (and still are) subject to a 30% withholding rate under section 1441. By virtue of a subsequent amendment to section 864(b) of the Code, they are ultimately subject to tax on a net basis at the regular graduated rates.*/

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*/ Section 102(c) of the Foreign Investors Tax Act of 1966 amended section 864 of the Code to provide that an individual performing personal services in the United States will be considered as engaged in a trade or business within the United States. Under section 871(b), the effectively connected income of a nonresident alien individual who is engaged in a trade or business in the United States is taxable at the graduated rates of tax.

Rationale for Proposed Amendment

The technical correction preserving the 14% withholding rate for students, trainees and research fellows should be extended to foreign teaching fellows for the following reasons:

- To prevent significant overwithholding of tax. Since foreign teaching fellows are ultimately subject to tax at the regular graduated rates on a net basis, withholding at a flat 30% rate will result in a gross amount of overwithholding. Teaching fellowships, unlike regular faculty appointments, provide the recipient with only a modest stipend to cover the individual's living expenses here in the United States. The fact that virtually all such expenses are ultimately deductible, thus entitling the visiting scholar to a large tax refund after he has returned home, is of little consolation. The attached numerical example illustrates this point using figures drawn from the Fulbright educational exchange program.

- To equalize the tax burdens imposed on foreign and U.S. exchange lecturers. U.S. lecturers going abroad on a grant from the U.S. government apparently are not subject to any withholding of U.S. tax. Even if such compensation were treated as wages subject to withholding under section 3402(a), they would still be significantly better off than foreign lecturers coming here. They could adjust their withholding to reflect the amount of their anticipated deductions, thus resulting in a relatively small reduction in the value of their stipends. The attached numerical example illustrates the differential tax burdens imposed on foreign and U.S. scholars.

- To preserve U.S. government-sponsored academic exchange programs. If grants to foreign exchange lecturers and teachers remain subject to a 30% withholding liability, U.S. government grantors, such as the U.S. Information Agency, and other nonprofit U.S. grantors, will have to increase the size of their grants -- at least for fellowship recipients from nontreaty countries. Such measures will necessarily result in a reduction in the overall number of grants awarded. Overwithholding not only promotes an inefficient use of U.S. government program funds but also makes educational exchange programs more difficult to administer. To the extent that excessive withholding is imposed on foreign government-funded programs (which generally are administered by U.S. nonprofit agencies), it will discourage foreign cooperation and may ultimately lead to a drastic reduction in the number of foreign exchange scholars coming to the United States.

Mechanics of Proposed Amendment.

Amend the proposed technical correction to add the phrase "teaching or lecturing" to the list of academic activities in the United States to which the 14% withholding rate would be applicable. Delete the words "as a scholarship or fellowship" so that any amount granted to an F-, J- or M- visaholder by a 501(c)(3) organization, the U.S. government, a foreign government, an international organization or commission for study, training, research, lecturing or teaching in the United States would qualify for the 14% rate. A copy of the proposed statutory language, redlined to indicate the amendment, is attached.

Exhibit A
Draft Statutory Lanuage

The second sentence of section 1441(b) is amended to read as follows:

"The items of income referred to in subsection (a) from which tax shall be deducted and witheld at a rate of 14 percent are amounts which are received by a nonresident alien who is temporarily present in the United States as a nonimmigrant under subparagraph (F), (J) or (M) of section 101(a)(15) of the Immigration and Nationality Act and which are --

(1) incident to a qualified scholarship to which section 117(a) applies, but only to the extent includible in gross income; or

(2) in the case of an individual who is not a candidate for a degree at an educational organization described in 170(b)(1)(A)(ii), granted by --

(A) an organization described in section 501(c)(3) which is exempt from tax under section 501(a),

(B) a foreign government,

(C) an international organization, or a binational or multinational educational and cultural foundation or commission created or continued pursuant to the Mutual Educational and Cultural Exchange Act of 1961, or

(D) the United States, or an instrumentality or agency thereof, or a State, or a possession of the United States, or any political subdivision thereof, or the District of Columbia,

~~as a scholarship or fellowship~~ for study, training, research, lecturing or teaching in the United States."

Exhibit B

Differential Taxation of U.S. and Foreign Exchange Lecturers and Teachers

For purposes of the numerical examples presented below, the following assumptions apply:

Grant Amount:	$22,000
Taxpayer Status:	Married, 1 dependent
Deductible Expenses:	$10,000
Other income:	0

The foreign scholar is a J visaholder and a nonresident alien for U.S. tax purposes. The grant is a 10-month exchange lectureship awarded by the U.S. government. Under the terms of the grant, the scholar may not remain in the host country for longer than 2 years. Prior to receiving the grant, both the foreign and the U.S. scholar held faculty positions in their home country to which they plan to return.

	Foreign Scholar	U.S. Scholar
Amount Includible in Income:	$22,000	$22,000
Personal Exemptions:	$ 1,900	$ 5,700
Deductions:	$10,000	$10,000
Taxable Income:	$10,100	$ 6,300
Withheld Tax:		
(at 30% rate)	$ 6,030	
(at graduated rates)		$ 1,191
Ultimate Tax Liability:	$ 1,395	$ 825
Refund (amount overwithheld):	$ 4,635	$ 366

COUNCIL OF GRADUATE SCHOOLS IN THE U.S.
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July 10, 1987

Mr. Robert J. Leonard
Chief Tax Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

In response to the Committee's request for comments on the proposed Technical Corrections to the Tax Reform Act of 1986 introduced as H.R. 2636, we are writing in support of a proposed technical correction that would clarify the Tax Reform Act of 1986 (PL 99-514) in Section 127(c)(8) and continue to allow graduate students engaged in part-time teaching or research to exclude from taxable income tuition grants provided in conjunction with these services.

Early in the House consideration of the Tax Reform Act of 1986 it was decided to make the non-tuition portion of scholarships and fellowships subject to tax. We do not believe that there was any debate over the status of fellowships that contain teaching or research components. At a later date in the development of the 1986 Tax Bill, Section 127 was extended to continue employer provided tuition benefits. Section 127 excludes tuition reduction grants from taxable income even where some teaching or research is required. The House Report (H. Report 436, 99th Congress., 1st Session 102, 7 Dec. 1985) makes note of this as follows: "In addition, section 1161 of the committee bill extends the availability of the tuition reduction exclusion for certain graduate students an additional two taxable years beyond its scheduled expiration for taxable years beginning after December 31, 1985, as part of the extension of section 127 under the bill." No specific mention of these topics is made in the Conference Report on the Tax Reform Act except the general notation that the conferees adopted the House provisions.

The use of tuition reduction grants is widespread in graduate education. Part-time work as a teaching or research assistant is an integral part of advanced degree programs in most disciplines. It is part of the uniquely successful American graduate education process that combines learning with teaching, research and often public service in practical as well as theoretical frameworks to produce scholars and scientists who find work in business, industry, and government, as well as in universities and colleges. Such flexibility enhances the ability to move successfully between the campus and an increasingly varied research workplace.

In this time of concern for American competitiveness, the provision of continued unambiguous exclusion of tuition reduction grants provided in conjunction with part-time services in completion of degree requirements is extremely important to ensure that talented graduates are not discouraged from pursuing careers in scholarship and research. In addition, such a result would do no damage to the basic principle established by the 1986 Tax Act, that non-tuition portions of scholarships should be subject to tax. To conclude otherwise seems to ignore the House Committee's language and intent, and would produce the inequitable result that a person who receives a full tuition scholarship would pay no tax, while an individual who receives a tuition reduction scholarship with a teaching or research requirement would be subject to tax. A technical correction to end this confusing situation would provide relief to the most often used mechanism providing support to graduate students in advanced degree programs.

This letter is also sent on behalf of the following education associations: American Council on Education, Association of American Universities, Association of Urban Universities, American Society for Engineering Education, National Association of State Universities and Land-Grant Colleges, the National Association of Independent Colleges and Universities, and the Council on Governmental Relations.

Sincerely,

Jules B. LaPidus
President

FRANK J. GUARINI
14TH DISTRICT
NEW JERSEY

COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON TRADE

SUBCOMMITTEE ON OVERSIGHT

SELECT COMMITTEE ON
NARCOTICS ABUSE AND CONTROL

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House of Representatives
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July 15, 1987

Hon. Dan Rostenkowski
Committee on Ways & Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Danny ~~Mr. Chair~~man:

I am writing in support of a proposed technical correction which would clarify that Section 127(c)(8) continues to allow graduate students engaged in part-time teaching or research to exclude tuition grants provided in conjunction with these services from taxable income.

Early in the process we decided to make the non-tuition portion of scholarships and fellowships subject to tax. I do not think there was any debate at that time about tuition scholarships which had teaching or research components. Although we did adopt the Administration's proposal in this area (which would have taxed such tuition remissions), later in the mark up process we extended section 127, which excludes tuition reductions from taxable income even where some teaching or research is required. The House Committee Report makes brief mention of this as follows," In addition, section 1161 of the committee bill extends the availability of the tuition reduction exclusion for certain graduate students an additional two years beyond its scheduled expiration for taxable years beginning after December 31, 1985, as part of the extension of section 127 under the bill." H.Rep. No. 426, 99th Cong., 1st Sess. 102 (December 7, 1985).

I think a rational reading of that sentence is that such amounts are excludable from tax. It is my understanding that the Senate staff shares this view. I hope that we can concur in this conclusion. To conclude otherwise ignores the House Committee's language and produces the inequitable result that a person who receives a full tuition scholarship would pay no tax, while an individual who receives a tuition scholarship which has a teaching or research requirement added to it would be subject to tax. In addition, such a result does no damage to the basic principle that the non-tuition portion of scholarship grants should be subject to tax.

Sincerely,

Frank

FRANK J. GUARINI
Member of Congress

INSTITUTE OF INTERNATIONAL EDUCATION
809 UNITED NATIONS PLAZA, NEW YORK, N.Y. 10017

WRITER'S DIRECT DIAL NUMBER IS (212)

July 13, 1987

Mr. Robert J. Leonard
Chief Tax Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

The Institute of International Education is the largest and most active international educational exchange organization in the United States. IIE administers programs through which more than 9,000 men and women from approximately 120 countries study, conduct research, teach, or provide scientific, technical, or administrative expertise in countries other than their own. Among the more than 175 sponsors of these programs are the United States and foreign governments, foundations, corporations, universities, binational agencies, and international organizations.

I write today to endorse strongly the comments presented by Norman Peterson on behalf of the Liaison Group in response to the Committee's request for comments on proposed technical corrections to the Tax Reform Act of 1986. We share in Mr. Peterson's expression of gratitude to the staff of the Committee for their efforts to date and certainly agree that inclusion of a provision to extend the lower 14 percent withholding rate to certain foreign students and scholars holding (F),(J), and (M) visas is an important and useful step toward resolving one area of concern. We respectfully urge the Committee to retain this amendment to H.R. 2636 in the final legislation.

Nevertheless, we are convinced that more comprehensive remedies are required to correct the very serious present and likely future implications resulting from the changes to the tax treatment of scholarships and fellowships brought about through passage of the Tax Reform Act of 1986. We have, during the course of attempting to assess the impact of those changes, uncovered several pertinent issues which we believe should be brought to the attention of the Committee but, since they may well be beyond the scope of H.R. 2636, we will address them in a separate letter.

Once again, I would like to express our appreciation for the opportunity to comment on the current technical corrections.

Sincerely,

Richard W. Dye

Richard W. Dye
Executive Vice-President

INSTITUTE OF INTERNATIONAL EDUCATION
809 UNITED NATIONS PLAZA, NEW YORK, N.Y. 10017

WRITER'S DIRECT DIAL NUMBER IS (212) 984-5442

July 21, 1987

Mr. Robert J. Leonard
Chief Tax Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

By separate letter, the Institute offered its strong endorsement of the comments made by Norman Peterson, on behalf of the Liaison Group, in response to the Committee's request for comments on the proposed technical corrections to the Tax Reform Act of 1986. Therein we noted that there are several pertinent issues which we believed should be brought to the attention of the Committee even though they might very well be outside the scope of H.R. 2636.

During the course of our investigation of the effects of the recent changes to section 117 and the resulting impacts on other sections of the Code, we became concerned about a very real threat of financial hardship and administrative confusion as well as the possibility of a potentially embarassing situation with regard to U.S. foreign policy and the administration of U.S. government sponsored educational exchange programs. Accordingly, we respectfully offer the following observations and comments for the Committee's consideration.

U.S. Sponsored Educational, Training and Cultural Exchange Programs

The U.S. government, especially through the funding provided by the U.S. Information Agency and the U.S. Agency For International Development, sponsors thousands of non-resident alien grant recipients as students, trainees and cultural exchange visitors. Such visa sponsorship carries the responsibility to guarantee that the financial needs of these grantees are met. As a result, the U.S. government assumes financial responsibility to the extent that tax withholding or tax liability reduces the grantee's available funds to below the level needed to meet required expenditures. Subjecting grantees funded by U.S. government agencies will therefore produce no additional revenue to the Treasury. In fact, there is a net loss in revenues since the government must bear the costs associated with withholding, reporting, and providing tax information and guidance for these thousands of grantees. It should also be noted that a significant number of these grantees, due to the design of many of these programs, are eligible to exclude most, if not all, of the amounts received as job-related educational expenses under section 162. Unfortunately, there are no provisions available to non-resident aliens to permit reduced withholding in light of the ultimate reduction in liability brought about by the deduction from gross income permitted by applying section 162.

Congress has consistently demonstrated positive intent to fund exchange programs. Increases in the program budgets for U.S.I.A. and A.I.D. are proof of that. To require tax withholding and reporting on the grantees funded by these programs merely shifts a portion of these agencies' budgets back to the Treasury, which we do not believe is an intended result.

We believe that this problem should be addressed by amending section 117 to exclude payments made to (F), (J) or (M) visa holders under U.S. government sponsored educational, training and cultural exchange programs.

Scholarship, Fellowship and Training Grants From non-U.S. Sponsors

Changes made to section 117 have exposed grant funds provided to (F), (J) and (M) visa holders by foreign governments and other foreign organizations to U.S. tax withholding and, possibly, tax liability. This has resulted in the creation of significant ill-will toward the U.S. by these entities. There is a distinct possibility that foreign sponsors may decide to discontinue the use of U.S. institutions as training sites and transfer their programs to any one of the many nations which do not tax foreign grant recipients. Such action on the part of these sponsors would result in the loss of needed revenue to our colleges and universities, reverse the trend toward internationalizing the U.S. educational perspective, and provide other nations with an increased opportunity to influence the political, economic and cultural relationships formed by these grantees as they prepare to assume future roles as their countries' policymakers.

It is our opinion that the loss of foreign exchange, cultural as well as monetary, would be far more damaging to the U.S. than would be the marginal revenue loss resulting from excluding these grant funds from U.S. taxation.

One effective approach to these difficulties would be amendment of section 862 to include grants made to non-resident alien (F), (J), or (M) visa holders in the definition of non- U.S. source income.

Overwithholding On Job-related Educational and Training Grants

There is a significant number of educational and training programs which are designed to enhance trade and business skills of the individuals enrolled in the programs. These grantees are entitled to deduct the costs for which their grant funds are provided from gross income as prescribed by section 162. No provision is made to permit these grantees to adjust the amount of withholding required under section 1441 to reflect the reduced tax liability ultimately due. This, of course, results in a serious overwithholding situation with regard to these grantees. We believe that such a situation is unfair and is probably an unintended result of the complexities of the Tax Code. U.S. residents are permitted to adjust withholding in the face of excess itemized deductions, but non-resident aliens may request adjustments to withholding only with regard to effectively connected income. It seems reasonable that non-resident alien individuals enrolled in these job-related educational and training programs be entitled to similar protection from excessive withholding.

We believe that this overwithholding problem could be minimized through amendment of section 1441 to provide withholding agents with the authority to reduce withholding in those circumstances in which the withholding agent is reasonably certain that amounts paid will not result in taxable income to the payee.

Further, section 872(b)(3) excludes from gross income amounts received from a foreign employer by a non-resident alien employee present in the U.S. as an (F) or (J) visa holder participating in an exchange or training program. It should be noted that there are many instances in which the funding for these types of employees is provided by the home country governments or various foreign not-for-profit organizations. It seems clear that Congress had no intent to tax the training funds provided under these kinds of training programs yet the wording of the code section does not provide the flexibility required to keep pace with current international training program design.

Code section 872(b)(3) should be amended to include amounts paid by third parties to these training program participants. In addition, even though amounts received from foreign government employers by their employees enrolled in these types of training programs are excluded under section 893, it might, for purposes of administrative clarity, be beneficial to include foreign governments in the definition of foreign employer with regard to application of this code section.

Definition of "Qualified Educational Organization"

Section 117, as amended, defines a "qualified educational organization" as one being described under section 170(b)(1)(A)(ii). Such an organization must "normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on".

The Institute, not unlike other organizations similarly involved in the field of international education, is often required to design for U.S. government agencies and other sponsors practical training programs which cannot be taught at traditional educational or vocational institutions. Such programs require the establishment of customized training courses delivered by the employees of commercial companies or by consultants not affiliated with educational organizations. An example of such a program would include a four month intensive program in electrical generator maintenance taught by engineering employees of a large power generating company to non-resident alien trainees. Even though such a program would require a classroom and work-floor environment, regular study and testing, and lead to a certificate of course completion, the grantees would not be entitled to the exclusions afforded by section 117 because they were not enrolled in a "qualified educational organization". We do not believe that this outcome was intended by Congress.

We feel that section 117 should be amended to permit individuals enrolled in these specialized training courses to qualify for treatment under that section.

Implementing Foreign Grantee Withholding and Reporting Requirements

The Tax Reform Act of 1986 changes to sections 117 and 123 will result in a dramatic increase in the administrative burden to be borne by the international educational exchange community. These organizations must devise methods to accommodate the withholding and reporting requirements created by the recent legislative changes. No adequate reporting and withholding systems are commercially available. There is woefully little procedural guidance available to allow these organizations to adequately cope with their greatly increased responsibilities as withholding agents. These organizations must take steps to acquire sufficient understanding of complicated areas of the tax code, design systems to implement withholding and reporting, train their staffs to understand the implications of the tax changes, provide guidance to the grantees for whom they are responsible, and notify current and potential sponsors of the financial implications. The Institute, for example, must accomplish all of the above steps on behalf of an estimated 7,000 grantees on 200 programs, funded by 175 sponsors, involving application of code sections 102, 117, 127, 162, 861, 872, 893, 894, and 1441. We must incorporate procedures to properly handle the preparation and receipt of Forms 1001, 1042, 1042s, 4224, and 8233. Our computer system must be reprogrammed to permit required withholding on any of 60,000 annual payments, provide financial statements to grantees which will assist in the preparation of Forms 2063, 1040C and 1040NR. We have estimated that the cost to implement such a system will be approximately $300,000 (compared to our 1986 excess of revenues over expenditures: of $ 59,000) and seriously restrict our ability to deal with normal operating requirements because of the need to redirect the efforts of our most skilled staff. Other exchange organizations are faced with similar although perhaps less imposing versions of this overall problem.

All of this effort will result in reporting on all 7,000 IIE grantees, with initial withholding on approximately 3,000, and ultimate tax liability on no more than 500, many of whom are sponsored by the U.S. government.

The IRS has provided relief from reporting and withholding requirements on payments made to U.S. resident scholars and fellows. It seems that similar relief should apply with regard to non-resident alien grantees.

The Institute appreciates this opportunity to make these observations and to offer our comments regarding issues we feel are of critical importance to the international exchange community and the future of educational exchange programs.

We are of course available to provide whatever additional information and assistance we can to help clarify the issues we've raised herein.

Sincerely,

Frank J. Utecht, C.P.A.
Controller

Comments of Russell M. Robinson, II,
General Counsel to
The John Motley Morehead Foundation
on
H.R. 2636 and S. 1350
Submitted to the
United States House of Representatives,
Committee on Ways and Means

On behalf of The John Motley Morehead Foundation (the "Morehead Foundation"), a private foundation which offers scholarships to students to attend the University of North Carolina at Chapel Hill, I am writing to comment on H.R. 2636 and S. 1350 (the "Technical Corrections Bill"). We believe that the Technical Corrections Bill should include an amendment to correct an unintended result of the 1986 Tax Reform Act's provisions concerning the treatment of scholarships.

1. The Morehead Foundation.

In 1945, John Motley Morehead established the Morehead Foundation to provide for "the education and training, as leaders, of those who have been endowed by their Creator with the capacity for leadership." Mr. Morehead's purpose has been at the heart of the Foundation since its inception and continues to influence the Morehead Scholarship Program today.

The attributes desired in Morehead Scholars generally follow those of the Rhodes Scholarships to Oxford University, established in 1903 by the Cecil Rhodes Trustees of London. The trustees of the Morehead Foundation have borrowed liberally, with some modification, from the plan of organization, method of selection, and procedures of the Rhodes Program.

Morehead awards are based on the criteria of leadership, character, motivation, and scholastic ability. The Morehead Scholar must demonstrate leadership potential and the desire to enrich the general welfare of the community.

2. The Summer Enrichment Program.

The Summer Enrichment Program is an essential part of the Morehead Scholarship. It is based on the idea that the only way to fully develop the leadership potential of our best college students is to give them exposure during their undergraduate years to a wider world of experience where different kinds of leadership are required and exercised -- that is, to take them off campus and show them through actual participation how they can perform as leaders after graduation.

The Program has been approved by the Internal Revenue Service under Section 4945(g) of the Code and works as follows: In the summer before their freshman year Morehead Scholars begin with a course at Outward Bound or the National Outdoor Leadership School; they work with a public safety organization, such as the police department of a large city, before their sophomore year; they serve as an intern at the executive level of a private business before their junior year, and before their senior year they can serve as an intern with a governmental body or pursue some other course of practical study approved by the Foundation staff.

This leadership development program is the real heart of the Foundation's tax-exempt purpose. It uniquely distinguishes the Morehead Scholarships from any other undergraduate scholarships in the country, and its success has been dramatic and demonstrable. We believe that its curtailment or elimination by a tax not heretofore imposed would be a serious loss to the education of our most promising youth and a result not intended by Congress.

3. The 1986 Tax Reform Act.

The Tax Reform Act of 1986 enacted Section 117 of the Code, which exempts from federal income tax only scholarship awards that meet the definition of "qualified scholarships." The relevant parts of this new section are subsections (a) and (b), which read in full as follows:

> (a) GENERAL RULE. -- Gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii).
>
> (b) QUALIFIED SCHOLARSHIP. -- For purposes of this section-
>
> (1) IN GENERAL. -- The term "qualified scholarship" means any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses.
>
> (2) QUALIFIED TUITION AND RELATED EXPENSES. -- For purposes of paragraph (1), the term "qualified tuition and related expenses" means --
>
> (A) tuition and fees required for the enrollment or attendance of a student at an educational organization described in section 170(b)(1)(A)(ii), and
>
> (B) fees, books, supplies, and equipment required for courses of instruction at such an educational organization.

The above definition of "qualified scholarships" would not include the grants that finance the Summer Enrichment Program. We believe that this result is unintended and should be corrected.

The new tax would disrupt the Summer Enrichment Program. The Foundation asks its grant recipients to give up almost all of each summer during their entire undergraduate careers to participate in this leadership development course as an integral part of their training as Morehead Scholars. This commitment by the Scholars virtually precludes them from any summer employment, and the grants from the Foundation only cover the cost of their accepting assignments away from their homes and the college campus. Few, if any, of the Scholars would be financially able and willing to make that commitment if an income tax burdened them with a net loss. On the Foundation's side, the budget for the entire Morehead Program is very close and the cost of the Summer Enrichment Program is a substantial part of that budget. The Foundation could not undertake to pay the taxes for its Scholars (which itself would be taxable) without making the difficult choice between reducing the number of its scholarships and curtailing or eliminating the Summer Enrichment Program.

We do not believe Congress would have chosen to force such a retrenchment of a scholarship program that has heretofore scrupulously passed every test of tax exemption and has contributed so much to education in this State and elsewhere. The provisions dealing with scholarships were added to the new law at a late stage by the conference committee, and we feel that Congress did not consider their effect on a program like ours. We therefore very much hope a correction can be made.

4. Proposed Correction.

We believe the grants for our Summer Enrichment Program could be included as "qualified scholarships" by adding the following clause as Section 117(b)(2)(C):

> (C) grants approved under section 4945(g) for travel, meals and lodging reasonably and necessarily incurred in an internship or course of practical study which is part of a program of qualified scholarships and which requires the recipient of the grant to move to and live at a location away from the educational organization.

We have drawn this proposed amendment narrowly to cover only the prescribed expenses and only to the extent they are reasonable and necessary. Also, the expenses must be incurred in an off-campus internship that is part of a qualified scholarship program. We find an analogy for this concept in Section 119 relating to meals and lodging furnished for the convenience of an employer; and we have also required that the grants to cover those expenses must be approved under Section 4945(g).

We would like to get our proposed amendment considered as a part of the Technical Corrections Bill. We would welcome the opportunity to explain those reasons further and furnish additional information at any hearing before the Committee.

Russell M. Robinson, II
General Counsel to
The John Motley Morehead
Foundation

Comments Regarding Technical Corrections Needed to Resolve Inequalities of Tax Treatment of Foreign and U.S. Scholarship Recipients Resulting From Section 123 of the Tax Reform Act of 1986

Submitted to the Committee on Ways and Means
of the U.S. House of Representatives

By Norman Peterson, Executive Secretary
The Liaison Group for International Educational Exchange
1825 I St., NW, Suite 475, Washington, DC 20006

July 15, 1987

The Liaison Group for International Educational Exchange, a coalition representing major nonprofit organizations engaged in international educational exchange programs, is pleased to respond to the Committee's request for comments on proposed technical corrections to the Tax Reform Act of 1986. The organizations represented in the Liaison Group include the principal administrative organizations for the Fulbright Program, the Hubert Humphrey North-South Fellowship Program, the Agency for International Development's Participant Training Program, and other major federal international scholarship programs.

We are deeply concerned about the unintended impact on these programs of changes made regarding taxation of scholarships and fellowships by Section 123 of the Tax Reform Act. My comments are confined to technical corrections needed to resolve problems resulting from this section of the Act.

Before going into the substance of my comments, I want to express the Liaison Group's gratitude to the staff of the Ways and Means Committee and the Joint Tax Committee for its sympathetic approach to these concerns. Inclusion in H.R. 2636 of section 101(d)(2), which would extend the 14% withholding rate to certain foreign students and scholars holding F, J, and M visas, is a very important and useful step toward resolving one of our major concerns.

However, the far-reaching changes in scholarship and fellowship taxation made through Section 123 resulted in several severe though, we believe, unintended problems. More comprehensive remedies are, therefore, urgently needed within the technical correction legislation to deal with other dimensions of these problems.

In essence, Congress' decision to limit the extent to which scholarships and fellowships may be excluded from gross income has had the effect of exposing foreign students and scholars to extremely unfavorable provisions of tax law. As a result, there now exists a great disparity in tax treatment between foreign and American recipients of scholarships and fellowships for participation in international educational exchange programs.

The legislative history of Section 123 indicates that the provisions' principal motivation was to equalize taxation of funds used for educational expenses. For this reason, it is our hope that the Committee will seek to further this commendable policy objective by taking several steps to improve Section 101(d)(2) to remedy the inequality of tax treatment between those who receive scholarships and fellowships who are U.S. citizens and those who are nationals of other nations.

As you can well imagine, this problem has considerable urgency for our community since reciprocity is an essential ingredient to international educational exchanges. The growing perception abroad that foreign recipients of scholarships and fellowships are unfairly treated under U.S. tax law is extremely damaging to the conduct of our programs.

Here, in summary, are the problems needing resolution as a result of the scholarship and fellowship changes made through Section 123 of the Act:

Excessive taxation rates of foreign recipients of scholarships and fellowships

The Problem: It was the intention of Section 123 of the Tax Reform Act to expose scholarship and fellowship income to increased taxation. In doing this, we believe it inadvertently exposed foreign grant recipients to much higher effective rates of taxation. These higher rates are due to filing requirements which apply to 'F' and 'J' category nonimmigrants. Since such individuals must file taxes as nonresident aliens for a specifed number of years, these scholarship and fellowship recipients cannot reduce their taxable income by means of the standard deduction or by the use of more than one personal exemption (if they would otherwise be entitled to them). For this reason, many U.S. student recipients of awards will either fall below the threshold of taxable income or be only subject to modest taxation levels, while foreign recipients will in most cases be taxed on all amounts above $1950 and the taxation level for these recipients is very high.

Consider the hypothetical case of two recipients of a scholarship to participate in an international exchange program. One is a U.S. citizen who is married and has one child. The other is a foreign citizen, also married with one child. They each receive an award of $17,000, only $7,000 of which is used for qualified tuition or related expenses.

	The U.S. Student Recipient	The Foreign Student Recipient
Taxable Income	$10,000	$10,000
Withholding from Income	$0	$10,000 - 1,950 (personal exemption) -------- $8,050 x .14 -------- $1,127
Tax Liability	$10,000 - 5,850 (personal exemptions) - 5,000 (standard deduction) -------- $0	$10,000 - 1,950 (personal exemption) ------- $8.050 x .15 ------- $1,208

Suggested Solution: Allow foreign scholarship and fellowship recipients the option of filing as a resident alien for tax purposes. By allowing these individuals to be entitled to the standard deduction and (if eligible) to more than one personal exemption, the great inequality of taxation between foreign and U.S. recipients of scholarships and fellowships would be eliminated. Although the Tax Reform Act did not substantially modify the filing requirements of 'F' and 'J' nonimmigrants, the proposed change is warranted in the technical corrections legislation because it alleviates an unintended inequality of tax treatment resulting from passage of Section 123 of the Tax Reform Act.

This proposal could be implemented through an amendment to Section 7701(b)(5)(E) of the tax code to allow foreign teachers, trainees, and students to elect to be treated as "exempt individuals" and thus to satisfy the provisions of the substantial presence test for purposes of being treated as a U.S. resident for tax purposes. An individual making the election would be eligible to do so even for his first taxable year in the United States under the new "first-year election" provision of 7701(b)(4). The election could be made available only on a permanent basis, revokable only with the consent of the Commissioner.

Subjecting foreign recipients and organizations providing their grants to excessive withholding and reporting requirements

The Problem: While U.S. recipients of scholarships and fellowships are not subject to withholding on their awards (even though portions of their awards are subject to taxation), foreign recipients are subject to wihholding at either a 14% or a 30% rate (depending on whether or not a portion of their award qualifies for exclusion under Section 123). As a result, there is a great disparity of treatment between foreign and U.S. recipients of scholarships and fellowships. U.S. recipients benefit by having access to their full awards even if they may owe taxes on it, while foreign recipients' awards are reduced through the withholding process even if they ultimately owe little or no taxes upon them. This is a great hardship since foreign students receiving these awards usually have no other source of financial support and their stipends are based on standardized cost-of-living indices set to meet basic minimum expenses. In the case of those young scholars without other income who cannot meet the new statute's test of a qualified scholarship or fellowship, the required withholding rate of 30% is a staggering burden.

In addition, the organizations which provide scholarships and fellowships to foreign individuals are unfairly subjected to withholding and reporting procedures which do not apply to organizations only giving awards to U.S. recipients. There is no compelling reason for this inequality of treatment.

Since the thrust of Section 123 appears to aim at equalizing tax treatment of funds used for educational expenses, we believe this inequality should be reduced and hopefully eliminated.

Suggested solutions: Several options appear to be worthy of consideration, (one of which has been incorporated into the Technical Corrections bill as introduced).

— Amounts received by nonresident aliens temporarily present in the United States as nonimmigrant 'F','J', or 'M' visa holders which are incident to a qualified scholarship, or amounts received by such individuals from educational organizations, foreign governments, international organizations, Fulbright Commissions, etc. (as defined in section 101(d)(2) of H.R. 2636) could be specifically exempted from withholding requirements. This is, we believe, the fairest and best solution, since it provides true equality between foreign and U.S. recipients of scholarships.

-- The existing exclusion of amounts received for maintenance by recipients of scholarships or fellowships under the authority of the Foreign Assistance Act through Section 1441(c)(6) of the Tax Code could be extended to recipients of awards provided by organizations defined under Section 101(d)(2) of H.R. 2636. Alternatively, this extention could be limited to those receiving awards under the authority of the Mutual Educational and Cultural Exchanges Act of 1961 as amended. If this approach is adopted, we urge that amounts paid for travel should also be excluded from funds subject to withholding, since travel to and from the educational institution in the United States is, like room and board, an essential incidental expense to the educational program itself for the foreign student.

— Those whose awards do not qualify under the Section 123 definition of a qualified scholarship or fellowship could be made eligible for the lower 14% withholding rate. A provision to accomplish this has been included in H.R. 2636. The Liaison Group appreciates the inclusion of this provision, and urges the Committee to retain it in the legislation if the options defined above are not acceptable. A slight technical modification of the provision communicated to the Committee by Patton, Boggs, and Blow on behalf of the Council for International Exchange of Scholars should be approved if this approach is taken. This technical change would enable Fulbright Program lecturers and teachers to qualify for the 14% withholding rate.

Obviously, from our perspective, the first of these options is the most desirable approach. Any of these options, however, would be a useful step in resolving the withholding inequalities which have resulted from passage of Section 123.

Subjecting awards from foreign governments and organizations to U.S. taxation

The Problem: The Section 123 changes have exposed grants given by foreign governments or other foreign sponsors to highly unfavorable federal 'sourcing' policies under which such awards are subject to taxation. Although these sourcing rules have been in effect for many years, they were not consequential to the conduct of exchange activities because the awards were normally excludable from taxable income as a scholarship or fellowship through the provisions of section 117. Now that awards are not fully excludable, sourcing policy is crucial.

Under current policy governing funds for educational activities, an award to a nonresident alien individual is subject to taxation if the educational activity takes place in the United States. This policy is a very strong disincentive for foreign scholarship sources to send students to the United States. The United States currently enjoys an enviable position in attracting many thousands of these students to our institutions each year. These students not only help support our higher educational institutions and make them into the international institutions they must be if they are to train our students for today's world, they also bring substantial funds into our communities, providing a significant positive contribution to our balance of payments problems. These benefits are seriously threatened by the effects of Section 123, as foreign sponsors choose to send their students to hosting nations which are happy to receive the income and do not attempt to tax it.

Suggested Solution: A provision is needed in the technical corrections legislation which specifically excludes from U.S. source income amounts received by nonimmigrant individuals with 'F', 'J' or 'M' visas for educational programs from foreign scholarship or fellowship programs.

The Liaison Group appreciates this opportunity to make these recommendations to the Committee regarding the proposed technical corrections legislation and the needs of international exchange programs relating to this legislation. We are grateful to the staff of the Committee for the steps already taken in the legislation to relieve the serious inequalities between foreign and U.S. scholarship recipients which resulted from changes made in scholarship and fellowship taxation by Section 123 of the Tax Reform Act. I hope these additional suggestions are useful to the Committee in resolving these problems. Naturally, we are prepared to offer whatever additional assistance we can to the Committee toward this objective.

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July 8, 1987

Mr. Robert J. Leonard, Chief Tax Counsel
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

Thank you for the opportunity to comment on the technical corrections bill, H.R. 2636. The members of the Midwestern Universities Alliance hope the Ways and Means Committee will consider a change in the present interpretation of the scholarship and fellowship provisions of the Tax Reform Act.

In spite of what seems to be clear language in the House report to the contrary, we are advised by Committee staff that the provisions of section 117(c) apply to the tuition reductions granted to graduate assistants who heretofore qualified for an exclusion under section 127(c)(8). As you know, section 117(c) says that the exclusion does not apply to that part of a tuition reduction that is received as compensation. We would like the Committee to amend the law to be consistent with the House report and provide that section 117(c) does not apply to students who receive their benefits under 117(c)(8). The enclosed chart outlines our proposal. The critical sentence in the House report reads as follows:

> "In addition, section 1161 of the Committee bill extends the availability of the tuition reduction exclusion for certain graduate students an additional two years beyond its scheduled expiration date for taxable years beginning after December 31, 1985, as part of the extension of section 127 under the bill." H. Rep. No.426, 99th Cong., 1st Sess. 102 (Dec. 7, 1985).

Graduate students are selected to become research or teaching assistants because they have the potential to be the next generation of academic leaders and scientists, as well as executives in business, industry and government. Congress recognized that when section 127 became law. Clearly some members and/or staff believed that the tax reformers did not want to end the exclusion under section 127(c)(8). Otherwise, the sentence quoted above would not have appeared in both the report and the "blue book".

Finally, let me add that graduate assistants are given teaching and research assignments, in part, to augment their educational programs. They learn their future professions under the guidance of senior academic people. On that basis alone the exclusion is warranted. I hope you agree.

Sincerely,

Newton O Cattell

Newton O. Cattell
Director

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July 17, 1987

Mr. Robert J. Leonard
Chief Tax Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

The National Association for Foreign Student Affairs (NAFSA) respectfully submits this letter in response to the Committee's request for comments on the proposed technical corrections to the Tax Reform Act of 1986 contained in H.R. 2636. NAFSA wishes to commend to the Committee the letter of comment submitted by the Liaison Group for International Educational Exchange and to express its support for the positions expressed in that letter.

NAFSA is a nonprofit, professional membership organization representing over 5,600 members and 1,600 institutions active in international educational exchange. The association represents those individuals who advise foreign students and scholars, review foreign admissions credentials, teach English as a foreign language, organize community volunteer activities for international visitors, and advise U.S. students and scholars on study abroad. NAFSA is in its 40th year of professional activities in these areas and is a founding member of the Liaison Group.

The association has been very concerned about the impact of two recent changes in tax law which together pose serious problems for the participants, and their sponsors and institutions, in international educational exchange. Those two tax code changes are the revised definitions of "nonresident" taxpayers contained in section 138 of the Deficit Reduction Act of 1984 (DEFRA) and the reduced tax exemption of scholarships and fellowships contained in section 123 of the Tax Reform Act of 1986 (TRA).

With regard to H.R. 2636, NAFSA wishes to express its appreciation and gratitude to the staffs of the Ways and Means Committee and the Joint Tax Committee for the sympathetic consideration of proposals put forward on behalf of international exchange organizations by the law firm of Patton, Boggs and Blow. The decision to include one of those proposals--extending the lower 14 percent withholding rate to certain nondegree foreign students and scholars holding F, J, and M visas--is an important and useful step toward rectifying the identified problems regarding tax treatment of international exchange participants.

Without recapping the details of the letter submitted by the Liaison Group, NAFSA wishes to express concern about the overall impact of DEFRA and TRA with regard to two broad, public policy matters. First is the proper integration of U.S. tax policy with the long standing and accepted U.S. foreign policy of promoting international educational exchange. Second is the need to maintain reasonable equity under U.S. tax law for similarly situated individuals whether a foreign or domestic student or scholar.

NAFSA and its colleague organizations in international exchange are deeply troubled by the apparently unintended shift in U.S. tax policy that drains extremely limited U.S. government funding sources for international education grants from the intended recipients and back into the U.S. Treasury. While the association has no quarrel with the broadly stated policy of taxing portions of scholarships and fellowships, it is our belief that the taxation of U.S. government grants made through the U.S. Information Agency and the U.S. Agency for International Development is both counterproductive to U.S. foreign policy efforts and revenue neutral to the U.S. government. The net effect is that both agencies will be obliged to increase the size of individual grants to cover new tax expenses and thereby decrease the number of eventual recipients. Following the decline in number of participants, the agencies will be obliged to request additional funding to meet the targets for participants numbers encouraged by Congress. The impact of the tax law changes on this particular population is therefore frustrating to all parties--the U.S. government and its funded exchange participants--and the amendments advocated by Patton, Boggs and Blow and the Liaison Group provide several modest and reasonable solutions to this problem.

The international exchange community is also concerned that foreign students and scholars, similarly situated to their U.S. peers, face dissimilar and frequently much higher tax burdens. These burdens, as described in the examples provided by Patton, Boggs and Blow (enclosed with this letter), show dramatic inequities both in terms of withholding obligations and with regard to eventual tax liability. NAFSA believes as a matter of fairness, especially within the context of diplomatic concerns with our educational exchange partners throughout the world, that to the greatest degree possible a foreign student ought to have similar tax obligations to a similarly situated U.S. student. The association recommends to the Committee the proposals to achieve this equity put forward by Patton, Boggs and Blow and the Liaison Group.

In closing, NAFSA wishes to associate itself with the very important discussion of "sourcing" contained in the Liaison Group letter. Though not directly addressed in TRA nor a matter of tax code language, sourcing of foreign grants--particularly foreign government grants--to exchange students and scholars studying in the United States is rapidly growing into a serious international problem for this country that has been discovered only because scholarships and fellowships are no longer entirely exempt from tax liability. The results of this discovered problem threaten to do serious, long-term damage to the enterprise of international educational exchange in the United States and could cast grave doubts upon the perception of this country as the leading educator of the world's young adults. Several close U.S. friends in the world--both in Europe and the third world--are reportedly contemplating sharp reductions or elimination of government sponsored exchanges with the United States and may entertain retaliatory taxing of U.S. students and scholars participating in exchanges in their countries. The Liaison Group's discussion of this issue and its possible solution deserve the special attention and deliberation of the Committee.

NAFSA appreciates this opportunity to comment on the proposed technical corrections contained in H.R. 2636 and reiterates its thanks for the consideration given our concerns by congressional staff. While the association applauds the steps already taken to meet these concerns, it is our hope that the Committee can address the additional issues raised above. NAFSA would be pleased to assist the Committee in any way regarding these concerns.

Sincerely,

Josef Mestenhauser
President

Enclosures

Example 1 - Single Undergraduate

In example 1, the foreign taxpayer is a single foreign student pursuing a B.A. at a state university in the United States. In 1988, she received scholarship grants totaling $10,000. Of this amount, $5,000 was designated for and expended on tuition and related expenses; the remaining $5,000 was designated for travel, living and other expenses. The U.S. resident is a single American student who has received an identical grant at the same university. Neither student has any wage income or itemized deductions.

As indicated by the charts below, the American student will have virtually no tax liability; by contrast, the foreign student will owe over 9% of her subsistence-level living stipend in U.S. taxes. Due to her inability to utilize the standard deduction, the nonresident alien student will pay $450 more in taxes than a U.S. resident receiving an identical grant.

Chart 1 (Single Undergraduate)

	Foreign Student	U.S. Student
Amount Includible in Income:	$5,000	$5,000
Personal Exemption:	$1,950	$1,950
Standard Deduction:	N/A	$3,000
Amount Subject to Withholding:	$3,050	$ 0
Withheld tax (at 14% rate):	$ 427	$ 0
Amount Subject to Tax:	$3,050	$ 50
Tax Liability	$ 458	$ 8
Effective Rate (tax as a % of includible income):	9.2%	.2%

Example 2: Married Graduate Student

In example 2, the foreign student is a graduate student pursuing a masters degree at a U.S. university. In 1988, he received scholarship grants classified as U.S. source income totaling $18,000. Of this amount, $7,000 was designated for and expended on tuition; $11,000 was for travel and living expenses. He is married and has 1 child. His wife does not work outside the home. Chart 2 compares his tax liability to that of a U.S. student in the same financial and family circumstances. 7/

As Chart 2 illustrates, the foreign student will pay a substantial amount in tax -- $1,376, or 12.5% of his living and travel stipend, the greater part of which will be withheld in advance; by contrast, the American student will have an insignificant tax liability, and no tax will be withheld.

7/ For purposes of this example, it is assumed that neither student would be entitled to deduct educational expenses as a business expense.

Chart 2 (Married Graduate Student, 1 dependent)

	Foreign Student	U.S. Student
Amount Includible in Income:	$11,000	$11,000
Personal Exemptions:	$ 1,950	$ 5,850
Standard Deduction:	N/A	$ 5,000
Amount Subject to Withholding	$ 9,050	$ 0
Withheld Tax:	$ 1,267	$ 0
Amount Subject to Tax:	$ 9,050	$ 150
Tax Liability	$ 1,376	$ 23
Effective Rate (tax as a % of includible income)	12.5%	.2%

Example 3: Married Post-doctoral Research Fellow

In our third example, the foreign student is married with two children. He has been awarded a $22,000 fellowship to study and do research at a U.S. university. His tax liability is compared to that of a U.S. student in exactly the same financial and family circumstances.

Since neither student is a degree candidate, the entire amount of the fellowship grant will be subject to tax. In addition, the foreign student's grant may be subject to a flat

30% rate of tax.[8] This will result in the reduction of his living stipend by almost one-third.

Chart 3 (Married Research Fellow, 2 dependents)

	Foreign Scholar	U.S. Scholar
Amount Includible in Income:	$22,000	$22,000
Personal Exemptions:	$ 1,950	$ 7,800
Standard Deduction:	N/A	$ 5,000
Amount Subject to Withholding:	$20,050	$ 9,200
Withheld Tax:	$ 6,015	$ 1,380
Amount Subject to Tax:	$20,050	$ 9,200
Tax Liability	$ 6,015	$ 1,380
Effective rate (tax as a % of includible income)	27%	6%

8/ In the process of repealing the $300 per month exclusion, Congress inadvertently eliminated foreign nondegree candidates' eligibility for the reduced (14%) withholding rate under section 1441(b), thus subjecting them to the full 30% withholding rate established under section 1441(a). In addition, it also appears that the scholarship/fellowship income of nondegree candidates will no longer be treated as effectively connected and thus taxable on a net basis at graduated rates. Since section 871(c) limits such treatment to "income described in section 1441(b)(1) or (2)", the income of nondegree grantees (which is no longer described in that section by virtue of the section 117 amendments) thus will be subject to tax at a gross basis at a flat 30% rate. The restoration of 14% withholding and taxation on a net basis is the subject of a proposed technical correction to the 1986 Act.

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UNIVERSITY OF ARKANSAS . Office of the Chancellor

July 31, 1987

The Honorable Dan Rostenkowski
Chairman
Committee of Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

I am writing to urge that the Technical Corrections Act of 1987, H.R. 2636, contain a proposed technical correction that would clarify the use of Section 127(c)(8) to continue to allow graduate students engaged in part-time teaching or research to exclude tuition grants, provided in conjunction with these services, from taxable income. The Tax Reform Act of 1986 adopted provisions which would restrict the exclusion of income from scholarships or fellowships to the amounts received for tuition, fees, books, or equipment required for courses of instruction. However, Section 127 also was extended, which continued to exclude tuition reductions from taxable income even where some teaching or research is required. The House committee report, which was to guide the interpretation of the Tax Reform Act of 1986 in this area, makes brief mention of this in H. Report 436 where it notes that Section 1161 of the committee bill extends the availability of tuition exclusion for certain graduate students for two years as part of the extension of Section 127 (H. Report 436, 99th Congress., 1st Session 102, 7 Dec. 1985).

On this campus, 791 graduate students provide service in 67 different areas of study in connection with teaching or research that are now, and have been for some time, integral parts of their academic courses of study. In this time of attention to American competitiveness, the provision of continued unambiguous exclusion of tuition grants provided in conjunction with these services is extremely important. In addition, such result does no damage to the basic principle that the non-tuition portion of scholarship should be subject to tax.

Thank you for your consideration of this matter in the Technical Corrections Act of 1987.

Sincerely,

Daniel E. Ferritor
Chancellor

Letters similar to the above were received from the following--

Ball State University, Muncie, Ind., David L. Wheeler, Dean, Graduate School and Research

College of Saint Rose, Albany, N.Y., Sr. Marguerite E. Donovan, Chair, Business Administration/Economics Division

Dartmouth College, Hanover, N.H., P. Bruce Pipes, Dean of Graduate Study

Drew University, Madison, N.J., Merrill M. Skaggs, Dean, Graduate School

Fairleigh Dickinson University, Hackensack, N.J., Barbara Kellerman, Dean of Graduate Studies and Research

Georgian Court College, Lakewood, N.J., Sister Barbara Williams, President

Jackson State University, Jackson, Miss., Leslie Burl McLemore, Professor of Political Science, and Dean of Graduate Studies and Research Administration

Oregon State University, Corvallis, Ore., Lyle D. Calvin, Dean, Graduate School

Pace University, Pleasantville/Briarcliff Campus, N.Y., Charles D. Masiello, Chairperson, University Committee on Graduate Studies

St. Bonaventure University, St. Bonaventure, N.Y., Carol B. Diminnie, Dean, School of Graduate Studies

State University of New York at Buffalo, William C. Barba, Assistant Vice Provost

Texas Christian University, Fort Worth, Tex., John N Mangieri, Dean of Graduate Studies and Research

University of California, San Diego, Richard Attiyeh, Dean, Graduate Studies and Research

University of Miami, Fla., Pamela A. Ferguson, Dean of the Graduate School and Associate Provost

University of Missouri, St. Louis, Mo., Thomas E. Jordan, Associate Vice Chancellor, and Dean, Graduate School

University of San Diego, Calif., Edward F. DeRoche, Dean, School of Education

University of South Carolina, Columbia, S.C., Jeffrey S. Arpan, Director, International Business Programs

University of Utah, Salt Lake City, Utah, B. Gale Dick, Dean, Graduate School

University of Washington, Seattle, Wash., Gene L. Woodruff, Dean and Vice Provost for Research

Virginia Commonwealth University, Richmond, Va., John H. McGrath, Dean, School of Graduate Studies

Western Illinois University, Macomb, Ill., Suzanne Reid, Dean, School of Graduate Studies

Western Michigan University, Kalamazoo, Mich., Laurel Grotzinger, Dean, Graduate College

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July 30, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, DC 20515

Re: Technical Corrections Bill of 1987
(H.R. 2636 and S. 1350)

Dear Sir:

In response to your request for comments on the proposed Technical Corrections Act of 1987, I would like to comment on section 67 of the Internal Revenue Code as applied to estates and trusts, and section 101(f) of the proposed Technical Corrections Act.

First of all, it is not altogether clear to me that Congress intended section 67 and the two percent floor on miscellaneous itemized deductions to apply to estates and trusts. Section 67(a) refers to the case of an "individual," which is not defined in the Internal Revenue Code, but which is normally construed to mean a natural person, and not a corporation, partnership, estate, trust, or other entity. (See, for example, section 1 of the Code, which refers to "married individuals," "unmarried individuals," "estates," and "trusts.") Section 67(c) provides that regulations may prohibit indirect deductions through "pass-thru entities," but that the subsection does not apply to estates and trusts. An exception to the indirect provisions of section 67(c) for estates and trusts is meaningless if the general rule of section 67(a) applies directly to estates and trusts. The only reference to estates and trusts which indicates that section 67 should apply to estates and trusts is section 67(e) which, as will be explained below, either does not say what it is supposed to mean or is universally misunderstood.

The scant legislative history which is available suggests that Congress did not intend section 67 to apply to estates and trusts. As passed by the House, section 132 of H.R. 3838 would probably have applied to estates and trusts, even though it also referred to "the case of an individual," because the section contained a provision comparable to the present section 67(e). However, section 132 of the bill which was reported by the Senate Finance Committee would have added a similar section to the Internal Revenue Code, section 280H, referring only to individuals and containing no references to estates or trusts. The report of the Senate Finance Committee on the amendments to the House bill contains no relevant references to estates or trusts, but expressly refers to the deductions allowed under present law on Schedule A, lines 20 through 23, which is a clear reference to Form 1040, filed by individuals, and not Form 1041 filed by trusts and estates. (Schedule A of Form 1041 relates to the charitable deduction.) The tentative House-Senate Conference Agreement adopted by the Conferees on August 16, 1986, provides that the House recedes to "Senate provision on application of the floor to pass-through entities, with an emendment that it does not apply to estates, trusts, cooperatives, and REITs."

In this regard, I want to point out that it is a source of continuing amazement and outrage in the legal community that the legitimate and necessary administration expenses of an estate or trust may be denied in whole or in part, with the result that the beneficiaries of the estate or trust (most of whom, believe it or not, are widows or orphans) will be subject to tax on "income" which they have not received, could not receive, and never will receive.

It is therefore my opinion that Congress intended that section 67 should apply to estates and trusts only through the application (or nonapplication) of section 67(c), and that the inclusion of section 67(e) was an error. I would therefore suggest that section 67(e) be repealed, but that section 67(b) be amended in accordance with section 101(f)(4) of the proposed Technical Corrections Act.

Even if section 67 should apply to estates and trusts generally, section 67(e) seems to be miswritten or misunderstood. According to the Joint Committee Staff, the deductions under section 651 and 661, and certain administrative costs of an estate or trust, are not limited under the new two percent floor. However, that is not what is provided by the literal language of section 67(e). Section 67(e), both as it presently exists and as it would be amended by the proposed Technical Corrections Act, provides that, "the adjusted gross income of an estate or trust" shall be computed in the same matter as in the case of an individual, with certain adjustments for administration expenses, and, under the Technical Corrections Act, the distribution deductions. Lowering the adjusted gross income of an estate or trust does not mean that the administration expenses will be deductible, only that the floor to which the deductions are subject will be lowered by 2% of the deductions themselves. If administration expenses and distribution deductions are not subject to the 2% floor, which the Joint Committee Staff itself assumes to the case, those deductions should be specifically listed in section 67(b). (Even as amended by the proposed act, the distribution deductions under section 651 and 661 are still not among the itemized deductions included in section 67(b), which means that it is still possible for an estate or trust to be taxable on income which it has distributed to the beneficiary, and on which the beneficiary is also paying tax.)

In conclusion, let me repeat that the application of section 67 to estates and trusts makes no sense whatsoever, and those few instances in which the use of an estate or trust to realize a deduction which is not realizable by an individual can be covered by regulations under section 67(c) as amended by section 101(f)(4) of the proposed act.

Sincerely yours,

Daniel B Evans

DANIEL B. EVANS

July 27, 1987

Mr. Dan Rostenkowski, Chairman
House Ways & Means Committee
House Office Building
Washington, D.C. 20515

Dear Mr. Rostenkowski:

The purpose of this letter is to request that you consider reinstating the deduction for charitable contributions for those who do not itemize as it was in the 1984, 1985 and 1986 income tax returns.

Recent changes in tax laws (such as the larger percentage applied to medical expenses) have made it difficult to meet the requirements for itemizing. At the same time, lower levels of federal support for welfare and social programs have made it even more important for individuals to give to local causes. I believe people will continue to give, but the tax break will encourage them to give larger amounts.

Thank you for your consideration.

Very truly yours,

Paul L. Guth
Ruth Gillette Guth

Mr. and Mrs. Paul L. Guth
9150 - 34th Way No.
Pinellas Park, FL 34666

STATEMENT OF THE
INVESTMENT COMPANY INSTITUTE

I. INTRODUCTION

The Investment Company Institute, the association which represents America's mutual fund industry appreciates this opportunity to present its views on H.R. 2636, legislation making technical corrections to the Tax Reform Act of 1986. The Institute's membership includes 2,086 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members hold assets accounting for approximately 90% of total industry assets and have over 29 million shareholders.

Mutual funds clearly have become a highly preferred investment vehicle for millions of middle income investors and working Americans trying to accumulate savings and retirement income. They provide investors of moderate means the opportunity to obtain professional investment management and diversification of their investments. Over half of all mutual fund shareholders (excluding those in tax-exempt funds*) have household incomes of less than $50,000; forty percent have adjusted gross income under $40,000. Excluding money market mutual funds, thirty-eight percent of all fund shareholders are retired. Many of these retirees depend heavily on their mutual fund investments for day-to-day living expenses.

The subject of this statement is Internal Revenue Code Section 67(c): a provision added to the tax code in last year's tax reform measure. Absent timely congressional action Section 67(c) could adversely affect almost every mutual fund and mutual fund shareholder in America. As currently written, Section 67(c) will impute phantom taxable income, i.e., income not received but included in taxable income, to nearly 20 million U.S. taxpayers this year. Mutual fund households will have to pay taxes on $100 - $200 or more of income they never receive.

Fifteen members of the Senate Finance Committee recently joined in introducing S. 1489, a bill authored by Senator Moynihan to remove the discriminatory impact of Section 67(c) upon mutual funds and mutual fund shareholders. We hope that this Committee will agree that legislation similar to S.1489 would be a suitable technical change to last year's tax reform law which ought to be enacted as part of the earliest available legislative "vehicle."

Please consider the following reasons for enacting legislation similar to S.1489 as promptly as possible.

II. SECTION 67(c) VASTLY OVERSHOT THE MARK INTENDED BY CONGRESS LAST YEAR.

A. Section 67(c) Was Intended To Be a Narrow Anti-evasion Provision.

I.R.C. Section 67, added to the Code last year, imposes a two percent floor on certain "miscellaneous itemized deductions," including deductions under Section 212 for expenses incurred in producing investment income. Section 67(c) was added as one of hundreds of technical amendments at literally the last hour of the Senate's consideration of the Tax Reform Act. On its face it appears to be solely an anti-evasion or "loophole closing" provision: to prevent the indirect deduction through "pass-thru entities" of amounts not deductible if incurred by an individual directly.

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* Shareholders in tax-exempt funds have been excluded from these statistics because it appears that such funds may be largely unaffected by Section 67(c).

Theoretically, some sort of specialized "mutual fund" might be established by a handful of taxpayers seeking to avoid Section 67's restrictions -- although we believe that hypothetical possibility is farfetched. Were that to occur, the application of Section 67(c)'s "loophole closing" intent would be appropriate.

However, Section 67(c), as written, went far beyond that narrow prophylactic purpose. Regulations may be issued to effectuate Section 67(c) that would impute phantom taxable income to virtually all individual mutual fund shareholders in an amount equal to a portion of the operating expenses of their mutual fund. These operating expenses have, in the past, been recognized by the Internal Revenue Service as ordinary and necessary business expenses. Under the new provision, however, a fund shareholder will be treated as having personally incurred the expenses and (if he or she itemizes) will be permitted to deduct the expenses only if, together with the shareholder's other miscellaneous itemized deductions, the expenses exceed the two percent floor.

B. Section 67(c) Inappropriately Affects 20 Million Shareholders of Publicly Offered Mutual Funds.

It is patently ludicrous that a narrow anti-evasion provision should impute phantom income to 20 million shareholders of publicly-offered mutual funds. The more so when one considers that Section 67(c) will apparently impute income to nonitemizers as well as itemizers and that nonitemizers will in no event be able to deduct these expenses. Of these mutual fund shareholders who do itemize their deductions, only a small percentage will have expenses in excess of the two percent floor. Section 67(c) will thrust a peculiar new tax burden upon 20 million taxpayers which defies reality.

Who are these taxpayers? We can assure the Committee they are not wealthy manipulators of the tax code. Nor are they conversant with such arcane concepts as phantom income. Many shareholders are pensioners or working Americans building their retirement savings. They thought the Congress was reducing their overall tax burden last year via increases in the standard deduction and personal exemption amounts and decreases in the effective tax rates. They will be astonished next January to see on their Forms 1099 that the Congress actually cut those tax benefits by imputing to them significant amounts of phantom income.

C. The Phantom Taxable Income Created by Section 67(c) Unfairly Increases the Tax Burden of Mutual Fund Shareholders.

The impact of Section 67(c) will first be felt by mutual fund shareholders next January. They will receive a Form 1099 which includes in taxable income an amount greater than that which is reflected in their year-end statements of account or their own checkbooks.

The effective rate of tax on all mutual fund dividends will be increased significantly by Section 67(c). In the case of shareholders in equity funds, the effective tax rate on dividends will be increased by 20 percent or more for investors of every income level.

The penalty imposed by Section 67(c) falls even more heavily on older shareholders than it does on younger shareholders. This is because retirees depend heavily on their mutual fund investments for living expenses. In addition, elderly shareholders are less likely to be able to deduct any portion of the imputed income, because they either use the standard deduction or have insufficient miscellaneous deductions to exceed the 2 percent floor. A chart illustrating the impact of Section 67(c) on elderly shareholders has been attached as Attachment A.

D. The Enforcement of Section 67(c) Will Be An Administrative Nightmare.

And what will be the impact upon mutual funds and the U.S. government? In a word, chaos! Ease of entry and swift redeemability have been a hallmark of mutual fund investing. Trillions of dollars are invested and withdrawn from mutual funds each year. A severe administrative logjam could develop in identifying millions of individual shareholders and then allocating phantom income to them. It will be a worse problem for the government. The IRS will face an administrative nightmare in trying to collect the tax attributable to Section 67(c). The income reported on Form 1099, which will include Section 67(c) "phantom income", will disagree with shareholders' own records and yearly account statements received from the funds. Millions of shareholders will be confused by this discrepancy and will simply report on their tax returns the income they know they received. The result will be a mismatch between tax returns and 1099s, leaving the IRS in the unenviable position of trying to collect $30, $40 or $100 from millions of citizens who do not believe that they have underpaid their taxes.

E. Section 67(c) Puts Mutual Funds At An Unfair Competitive Disadvantage.

Finally, Section 67(c) might at least have made logical sense had it been applied to all competing investment products. But it applies to mutual funds alone. Even real estate investment trusts investing in securities are excepted from this provision even though REITs are taxed under the provisions of Subchapter M of the Code along with mutual funds. Virtually every investment product which competes with mutual funds is unaffected. This discrimination against mutual funds and mutual fund shareholders is illogical and is objectionable tax policy. Attached is a brief analysis which illustrates the discriminatory nature of Section 67(c) (Attachment B).

III. SECTION 67(c) WAS INAPPROPRIATELY ADOPTED AS A TECHNICAL AMENDMENT.

A. This Provision Was First Introduced on the Floor of the Senate Buried Among Hundreds of Technical Provisions.

I scarcely need remind the Committee that Congress is not in the habit of imputing phantom taxable income to millions of Americans by way of technical amendment or otherwise. It should not have happened here.

Section 67 was included in the House version of the tax reform legislation and was subsequently modified by the Senate Finance Committee. However, the provision that became Section 67(c) first surfaced only in the last hours of Senate floor consideration in a ninety-page package of technical provisions. We believe that the Senate floor managers assumed that every provision in that package was purely technical, nonsubstantive. They so assured the Senate. Without debate, the Senate thereupon approved the entire package. Yet, in the end, there was Section 67(c).

B. Section 67(c) Would Never Have Survived the Deliberative Process.

The mutual fund industry feels seriously aggrieved by last year's process. The deliberative tax reform process lasted for months. We participated actively while the tax reform bill moved through the Congress. There was never a hearing or even one minute of debate on the Senate floor about a proposal to impute phantom taxable income to mutual fund shareholders or to discriminate against mutual funds. To put it bluntly, we were denied any meaningful opportunity to oppose -- or even to comment on -- Section 67(c). But the failure of the normal legislative process to work was not merely a technical infirmity -- it had serious consequences.

Had Section 67(c) ever been proposed during the Senate's deliberative process, it never would have survived. Retrospective consideration of Section 67(c) finds a conspicuous absence of support:

- Secretary Baker has written to members of Congress stating that Section 67(c) was not required for revenue neutrality last year and urging its reconsideration;
- The House Conferees last year opposed the application of Section 67(c) to mutual funds and we believe that this Committee still maintains that position; and,
- Three quarters of the Senate Finance Committee members have sponsored S.1489, legislation modifying Section 67(c).

C. Section 67(c) Was a Dramatic, Substantive Change, Not a Technical Provision.

Now that the scope of Section 67(c) is understood, no one can seriously maintain that extending Section 67(c) to mutual fund shareholders generally was "technical." Section 67 of the Code is a provision which limits the deductibility of certain miscellaneous itemized deductions by individuals. Prior to the introduction of Section 67(c), mutual fund shareholders were unaffected by the debate on Section 67, because mutual fund expenses were appropriately treated as business expenses of the fund, not investment miscellaneous expenses of individuals deducted under section 212. By converting business expenses of a mutual fund into miscellaneous expenses of its individual shareholders, the introduction of Section 67(c) resulted in a dramatic, substantive change. Not only was this change inappropriate as a technical amendment, but any reasoned consideration of this change would have revealed it to be poor tax policy.

D. The Scope of Section 67(c) Was Unintentionally Broad.

The application of Section 67 to mutual funds through Section 67(c) is also not defensible as an anti-evasion device. No one would say that absent Section 67(c), 20 million mutual fund shareholders would suddenly be using their mutual funds to sidestep the restriction on Section 212 deductions. People invest in mutual funds to obtain professional investment management and diversification, not to engage in tax avoidance schemes.

Legislation similar to S.1489 would restore the original congressional purpose of this provision. It would leave Section 67(c) intact as an anti-evasion, loophole closing provision. With regard to mutual funds, it would restrict Section 67(c)'s application to taxpayers who somehow endeavor to use a mutual fund investment to circumvent Section 67, while eliminating the need for Treasury to impose a discriminatory phantom income tax upon the vast majority of mutual fund shareholders.

IV. RELIEF FOR MUTUAL FUND SHAREHOLDERS SHOULD BE ENACTED IMMEDIATELY.

For the reasons stated above, legislation similar to S.1489 clearly should qualify for inclusion in the technical corrections bill. We are concerned, however, that enactment of the technical corrections bill will be delayed beyond the time when effective relief will be possible.

Retroactive relief from Section 67(c) would be costly and unmanageable. Once shareholders begin filing their 1987 tax returns in January and February of 1988, correction of Section 67(c) would be an enormous administrative burden. Moreover, the lead time required to prepare 1099 forms to be mailed next January makes immediate relief appropriate.

We, therefore, urge the Committee to adopt legislation similar to S.1489 in the earliest available legislation.

V. REVENUE ESTIMATES ASCRIBED TO SECTION 67(c) AFTER THE FACT SHOULD NOT DETER CONGRESS FROM CORRECTING LAST YEAR'S ERROR.

A. Section 67(c) Was Introduced As a Technical Provision, Not Intended to Produce Any Revenue.

Secretary Baker has written to members of Congress that Section 67(c) was not required for revenue neutrality in last year's tax law. Indeed "technical provisions" are not supposed to yield independent revenues. We believe that no revenue was attributed to this provision either at the time it was proposed as a technical amendment on the Senate floor or at the time the President signed the bill into law.

We appreciate the Committee's concern about the revenue impact associated with various amendments to the tax law. I am sure you can appreciate our concern over the suggestion that revenue implications might prevent Congress from amending Section 67(c). Even though it is wrong as a matter of policy; was never intended to affect 20 million taxpayers; was never intended to impose a harsh competitive inequity on an industry; and was never intended to create administrative chaos for the government.

Here is a provision--now generally disdained--adopted only because it was proffered as a technical amendment and thus presumably not intended to produce independent revenue impact. Yet changing it may prove impossible because revenue came to be associated with it once it had been enacted? This is a Catch-22 of the highest order.

It would be most unfortunate if technicalities of the budget estimating process were to prevent the Congress from modifying a provision that will adversely affect 20 million taxpayers. The Committee should disregard the revenue impact ostensibly associated with Section 67(c). We are not familiar with the technicalities of the budgetary process. But it makes sense that something introduced as a technical amendment, not designed to produce revenue, should be corrected as a technical amendment, without being saddled with revenue consequences.

B. The Revenue Attributed to Section 67(c) Should Be Reduced Under An Appropriate Construction of the Law.

While we believe that equity requires correction of Section 67(c) without consideration of any revenue impact, the whole discussion of revenue should be put in perspective. We urge the Committee to consider the following points.

Secretary Baker has written that the upward limit of revenue impact could be as much as $530 million per year. This purely theoretical figure is valid only if Treasury, in regulations, imputes 100 percent of a mutual fund's expenses as income to its shareholders. This is an unrealistic assumption that does not comport with even the most extreme construction of the law.

The legislation directed that Treasury should determine those mutual fund expenses comparable to the expenses of an individual which are subject to the two percent floor. While we do not believe that the business expenses of a mutual fund are analogous to personal miscellaneous expenses, we have, nevertheless, done our best to draw the analogy.

The mutual fund industry has presented Treasury with two analyses--one which considered the industry at large and one which actually examined the practices of eight diverse funds--to ascertain that portion of a fund's expenses which could be viewed as comparable to those individual expenses subject to the floor and, therefore, to be allocated as income to shareholders under Section 67(c). These analyses demonstrate that the appropriate percentage is no more than 22 percent.

Under these analyses, the maximum annual revenue impact associated with congressional modification of Section 67(c) would barely exceed $100 million.

C. The Revenue Estimate Should Also Be Reduced for Non-compliance, Non-collection and Other Factors.

In practical terms, even the $100 million revenue figure ought to be discounted to recognize probable shortfalls attributable to noncompliance, noncollection and other factors. Experienced tax lawyers have predicted that many taxpayers will have already prepared their tax returns on the basis of year-end statements of account prior to receiving 1099s; many will not understand the imputed income and will not pay the additional tax. The IRS will face the choice of implementing costly collection procedures or foregoing the amounts of tax at issue. In either case, the potential revenue figure associated with Section 67(c) ought to be discounted.

VI. CONCLUSION

The defects in Section 67(c) are readily apparent and have been broadly acknowledged. A technical correction to restore the original congressional intent -- that Section 67(c) merely prevent evasion of Section 67 -- ought to be enacted in time to provide relief to taxpayers and to mutual funds this year.

ATTACHMENT A

IMPACT OF SECTION 67(c) ON OLDER SHAREHOLDERS

The significance of the fact that the numbers shown on these tables represent only average numbers may also be seen in Table 5, which illustrates the impact of section 67(c) on shareholders age 65 or older. Excluding money market fund owners, 38 percent of all mutual fund shareholders are retirees. In general, the section 67(c) penalty falls more heavily on shareholders in this age group for three reasons. First, retirees and older individuals generally own more investments than younger individuals in the same income class. Second, elderly shareholders are less likely to be able to deduct any portion of the imputed income, because they either use the standard deduction or have insufficiant miscellaneous deductions to exceed the 2 percent floor. Most importantly, retirees and older shareholders often rely heavily on their investments for living expenses and, therefore, tend to notice any decrease in the return on their investments. The penalty imposed under section 67(c) on mutual fund investors age 65 or over is even more substantial than that imposed on younger shareholders and is, therefore, even more likely to be disturbing to these shareholders.

The impact of the section 67(c) tax penalty on the elderly may also be analyzed in terms of its effect on the tax benefits otherwise gained by the elderly under the new law. By changing the personal exemption and standard deduction amounts available to the elderly, the 1986 Tax Reform Act increased the amount of income which may be earned by an elderly couple before any tax liability is imposed. On average, at least one quarter of this benefit is offset by the section 67(c) imputed income.

Average Tax Liability on Mutual Fund Dividends and the Effect of the 67(c) Gross-Up 1/ - Shareholders 65 Years of Age and Over; All Mutual Fund Types

(1986 Levels)

Income Class (Thousands of 1986 dollars)	Tax Liability on Mutual Fund Dividends, No 67(c) Gross-up	Additional Taxable income due to 67(c) gross-up	Additional Tax liability due to 67(c) gross-up	Percentage change in taxes on mutual fund dividends due to 67(c) gross-up
less than 10	$191	$137	$ 21	10.8%
10-20	190	132	20	10.4
20-30	414	241	46	11.1
30-40	590	260	62	10.6
40-50	931	343	98	10.5
50-75	1,200	417	122	10.2
75-100	1,591	453	146	9.2
100-200	1,734	541	168	9.7
more than 200	1,747	714	201	11.5
Total	601	278	61	10.2

1/ All tax calculations are performed separately for each taxpayer within each income class. The average of the individual calculations is then computed and reported here. Therefore, the results for each income class are the average for all taxpayers within that class, including itemizers and non-itemizers, joint and non-joint filers, etc.

Source: Price Waterhouse

May 25, 1987

ATTACHMENT B

COMPETITIVE EFFECT OF SECTION 67(c)

The attached chart graphically illustrates the adverse competitive impact of section 67(c) on the mutual fund industry. For the entire spectrum of the $800 billion plus mutual fund industry, there exists one or more competing investment product which is not similarly disadvantaged. As illustrated, each major type of fund competes with other investment vehicles for the dollars of investors seeking to purchase a debt, tax-exempt debt or equity investment. Not one of these alternative investment vehicles* is burdened with the investor penalty of section 67(c).

Examples of two products which compete directly with particular sectors of the mutual fund industry are bank money market deposit accounts and managed brokerage accounts invested in equity obligations. The impact of section 67(c) on money market mutual funds and equity mutual funds may be sufficient to tip the competitive balance in favor of the non-mutual fund alternative product.

1. Money Market Funds v. Bank Money Market Deposit Accounts

At the present time, approximately one-third of all mutual fund assets, some $230 billion dollars, are invested in money market mutual funds. By contrast, the bank money market deposit accounts, a financial product created by Congress in 1983 for the express purpose of competing with money market mutual funds, currently hold some $570 billion. The yield on bank money market deposit accounts is typically set at a level very close to that paid by money market mutual funds. However, bank money market deposit accounts have the additional benefit of FDIC insurance. With the impact of section 67(c) on the effective after-tax yield on money market mutual funds, the competitive balance will, in many cases, tip clearly in favor of the bank money market deposit account.

2. Equity Mutual Funds v. Managed Brokerage Accounts

Although equity mutual funds are not typically as yield sensitive as money market mutual funds, they also have a directly competitive alternative investment product. Moreover, investors in equity mutual funds may be even more likely to be motivated than shareholders in other funds to seek out an alternative investment vehicle because of the greater impact of section 67(c) on such funds. The overall expenses of equity funds tend to be greater than those of other funds. Moreover, such funds, because they try to maximize capital appreciation rather than ordinary income dividends, typically distribute relatively small amounts of divided income. For these two reasons (higher expenses and lower ordinary income dividends), section 67(c) may be expected to have a greater impact on shareholders of equity mutual funds than shareholders of other funds. As a percentage of yield, the shareholder's pro rata share of expenses subject to the two percent floor will be greater in an equity mutual fund.

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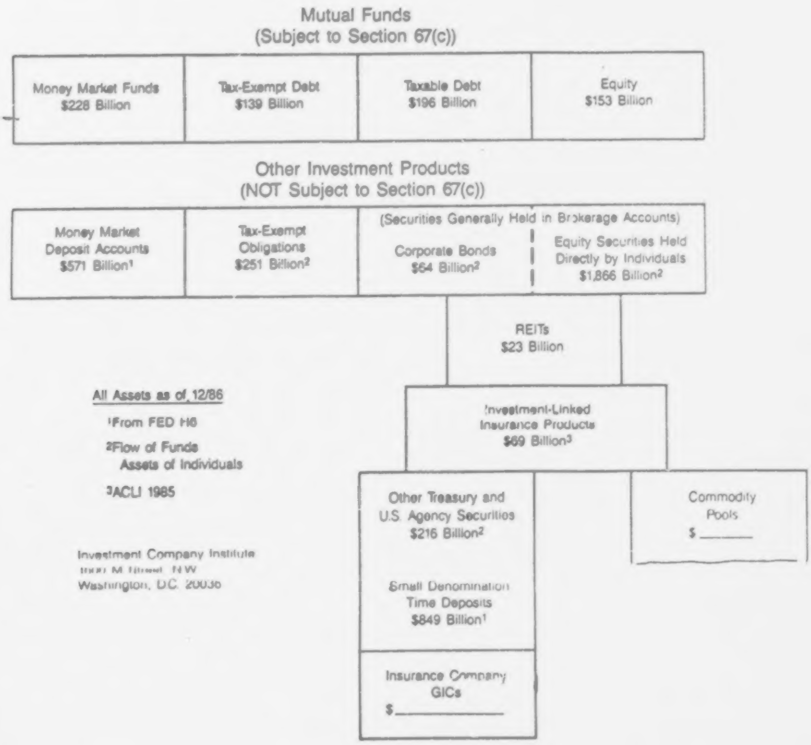
* Although it had been previously believed that commodity pools and other partnership investment products might also be affected by Section 67(c), it now appears that only mutual funds will be affected by the provision.

Investors seeking an alternative investment without the tax disadvantages of equity mutual funds can establish managed equity portfolio accounts with brokerage firms. These portfolios, which typically include stocks taken from the brokerage firm's approved list can be offered to customers of the firm with no investment charge for the investment advisory services. Only brokerage commissions, which are not subject to the two percent floor, will be paid by the investor for transactions within the managed equity account.

* * * *

The essential viability of the mutual fund industry has traditionally rested upon the absence of any tax disincentive to investor in mutual funds. The mutual fund investor has been treated, for tax purposes, comparably to the direct investor in securities. Section 67(c) represents a significant departure from this basic principle. It places the mutual fund investors in a less favorable tax position than many other direct investors and thereby places funds at a considerable competitive disadvantage.

COMPETING INVESTMENT PRODUCTS


Mutual Funds
(Subject to Section 67(c))
Money Market Funds
$228 Billion
Tax-Exempt Debt
$139 Billion
Taxable Debt
$196 Billion
Equity
$153 Billion
Other Investment Products
(NOT Subject to Section 67(c))
Money Market
Deposit Accounts
$571 Billion¹
Tax-Exempt
Obligations
$251 Billion²
(Securities Generally Held in Brokerage Accounts)
Corporate Bonds
$64 Billion²
Equity Securities Held
Directly by Individuals
$1,866 Billion²
REITs
$23 Billion
Investment-Linked
Insurance Products
$69 Billion³
Other Treasury and
U.S. Agency Securities
$216 Billion²
Small Denomination
Time Deposits
$849 Billion¹
Insurance Company
GICs
$ ________
Commodity
Pools
$ ________

All Assets as of 12/86

[1] From FED H6

[2] Flow of Funds Assets of Individuals

[3] ACLI 1985

Investment Company Institute
[illegible] M Street, N.W.
Washington, DC 20036

H. JAMES SAXTON
13TH DISTRICT, NEW JERSEY

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SUBCOMMITTEES:
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SUBCOMMITTEES:
HEALTH AND LONG TERM CARE

August 25, 1987

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Rostenkowski:

Enclosed is a copy of a letter I received from my constituent, George Korradi.

Mr. Korradi is concerned about the provision in the 1986 Tax Reform Act that requires mutual fund operators to report as income to shareowners a portion of their operating expenses.

Mr. Korradi questions how this provision can be justified, particularly in light of the fact that the expenses of the fund operations are paid by the shareowners before dividends are paid.

As the Ways and Means Committee continues work on the Technical Corrections Act, or otherwise considers tax legislation, it is my hope that this particular situation will also be given consideration.

Thank you for your attention to this matter.

Sincerely,

J Saxton

H. JAMES SAXTON
Member of Congress

HJS/jv
enc.

REPLY TO:
☐ 324 CANNON BUILDING
WASHINGTON, DC 20515
(202) 225-4765

☐ P.O. BOX 38
116 HIGH STREET
MT. HOLLY, NJ 08060
(609) 261-5800

☐ 23 CRESTWOOD VILLAGE
SHOPPING CENTER
WHITING, NJ 08759
(201) 350-3635

☐ 1 MAINE AVENUE
CHERRY HILL, NJ 08002
(609) 428-0520

July 24, 1987

Honorable H. James Saxton
Washington, DC 20515

Dear Honorable Sir:

Belatedly I acknowledge receipt of your letter dated June 15 in which you enclosed a copy of a letter you received from Thomas R. Martin of the Internal Revenue Service trying to justify the provision in the 1986 Tax Reform Act that requires mutual fund operators to report as income to share owners a portion of their operating expenses.

Bear in mind the expenses of fund operations are paid by the share owners before dividends are paid. How then can these same expenses be reported as additional income to the share owner and subject to income tax?

Martin states that current law allows funds (he calls them "pass thru entities") to deduct business expenses without limitation. He then states individual's itemized expenses must now exceed 2% of adjusted gross income. He is mixing oranges and bananas. One is a business expense and the other is a personal expense.

Every corporation deducts all expenses before declaring a dividend. A mutual fund operator does the same thing. The tax act doesn't require the corporation to report as additional income to the shareholder part of their operating expenses. Why then single out a shareholder of a mutual fund?

If I deposit $3,000. in a bank savings account, the bank deducts all their expenses before paying me interest.

The personal expense limitation pertains to personal expenses incurred by the taxpayer such as annual fee on safety deposit boxes, subscriptions to financial newsletters, employing a financial advisor, etc. They do not pertain to legitimate business expenses incurred by any commercial enterprise.

It is unbelievable that you and the other members of Congress would enact legislation that is obviously ridiculous. You haven't received complaints from your constituents as yet because none of them realize this proviso is part of the 1986 Tax Reform Act. However, when the 1099's DIV are received in January, showing the dollar dividends received plus an additional amount of fund expenses that must be reported as taxable income, you will be snowed under with complaints. That is when the mud will hit the fan.

Obviously you and the 2 Senators did not know about this section of the Tax Reform Act as they were unable to explain why legitimate business expenses should be taxed as income. Please take action to get this crazy provision repealed before April 15, 1988.

Sincerely,
George E. Korradi
41 Buckingham Dr
Vincentown, NJ
08088

rnal Revenue Service
Department of the Treasury

Washington, DC 20224

Person to Contact:
Peter L. Greenfield
Telephone Number:
566-3606
Refer Reply to:
D:R:T:F:C:GS 72582
Date:
MAY 13 1987

The Honorable H. James Saxton
House of Representatives
Washington, DC 20515

RECEIVED
MAY 22 1987
H. James Saxton, M
h Cong. Dist. of N

RECEIVED
MAY 27 1987
H. James Saxton, M.C.
Washington, D.C.

Dear Mr. Saxton:

This is in reply to your April 10 correspondence on behalf of Mr. George E. Korradi, who wrote to you concerning [redacted]

Generally, income from investments is included in gross income and expenses incurred to earn the income are deducted on Schedule A, Form 1040. In the case of pass-through entities, however, profits are paid to the investor after related expenses are deducted by the entity. Current law provides that business entities generally may deduct business expenses without limitation. However, current law also provides that an individual's miscellaneous itemized expenses, including expenses connected with investments, may be deducted only if they exceed 2 percent of the taxpayer's adjusted gross income. Therefore, by making an investment in a pass-through entity, a taxpayer can avoid this 2-percent limitation. This will allow a recipient of income from a pass-through entity to pay tax on a net lower amount of income than the recipient of income from another type of investment, based on equal investments and rates of return.

Accordingly, Internal Revenue Code section 67(c) states that the Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entitites of amounts which are not allowable as a deduction if paid or incurred directly by an individual and which require such reporting as may be necessary to carry out the purposes of this subsection. These regulations are currently being drafted to implement this provision.

We hope our letter will be helpful to you in responding to Mr. Korradi. If we may be of further service, please let us know.

Sincerely

Thomas R. Martin

Thomas R. Martin
Chief, Field Programs Branch

BEST AVAILABLE COPY

Section 135

COMMENTS OF THE HONORABLE JAMES L. OBERSTAR
OF MINNESOTA
TO THE COMMITTEE ON WAYS AND MEANS
ON H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987.

ADOPTION EXPENSES TRANSITION PERIOD SHOULD BE INCLUDED IN TECHNICAL CORRECTIONS

July 16, 1987

Mr. Chairman, the Tax Reform Act of 1986 repealed a modest $1500 tax deduction to allow families to adopt children with special needs, thus removing the only recognition in the Tax Code of the unique needs of families who choose to build a family through the adoption of special needs children. I was deeply concerned about the change, and would have preferred that the deduction for these children remain in the code. As an adoptive parent and Co-chair of the Congressional Coalition on Adoption, I have always believed that all of the costs related to adoption of special needs children, and they are considerable, should be deductible in order to encourage adoption and to remove one of the most significant barriers to adoption -- the cost.

The 1986 Act replaces the deduction for adoption of children with special needs with a new entitlement program under Title IV-E of the Social Security Act which would allow states to directly reimburse families who adopt these children for some or all of their expenses. Several adoption organizations, including the National Committee for Adoption and OURS, Inc., a national network of adoptive parent groups, feared that this new provision would create an unnecessary and inefficient bureaucratic disbursement system which might prevent some families from receiving their due benefits.

Unfortunately, the fear that bureaucratic problems and delays might strangle this new program in its cradle seems to be materializing. Since the Tax Reform Act became law, the U.S. Department of Health and Human Services has done little to implement this new provision. Despite promises of expediency, to this date no regulations have been promulgated; not even draft regulations have been released. Because I was concerned about potential delays in implementing this program which might prevent eligible parents from receiving benefits under the new program, I introduced legislation at the end of the 99th Congress to provide for a transition period for the direct reimbursement program. I reintroduced this measure in the 100th Congress on February 2, 1987, as H.R. 914. This measure reads simply:

> The amendments made by section 135 shall apply to taxable years beginning after December 31 of the calendar year in which final regulations are issued to implement the reimbursement of nonrecurring adoption expenses under any

adoption assistance agreement under subtitle E of Title IV of the Social Security Act.

No deduction shall be allowed with respect to amounts paid for adoption expenses directly related to the legal adoption of a child with special needs under section 222 of the Internal Revenue Code of 1986 to any taxpayer receiving reimbursement for such amounts under any adoption assistance agreement under subtitle E of title IV of the Social Security Act.

The purpose of the denial of double benefit clause is to ensure that no adoptive parents could claim a tax deduction for expenses incurred that were paid for through any government program.

I am also deeply concerned about the ability of states to administer the program once regulations have been placed in effect. This program could prove enormously complicated and cumbersome, and will take many months for the states to prepare reimbursement protocols and programs. In the meantime, a transition period such as the one I have proposed is crucial to the continued integrity and efficiency of the program.

I urge the Committee to add this language to H.R. 2636, the Technical Corrections Act of 1987. This would correct the lack of a transitional program in the bill, and would ensure adoptive parents are reimbursed for special needs adoptions. Without this transition period, many of these parents would be caught without adequate reimbursement for special needs adoption, and many parents considering special needs adoption may be forced to reject the idea out of concern that they might not be reimbursed for their expenses. In the 1986 Tax Act, Congress once again acknowledged the clear and compelling public policy goal of encouraging special needs adoption through a reimbursement program; we must not allow bureaucratic delays to threaten that Congressional commitment. For your information, I have enclosed a copy of my bill with this statement for your review. Thank you for your consideration.

100TH CONGRESS
1ST SESSION

H. R. 914

To provide a transition period for the full implementation of the nonrecurring adoption expenses reimbursement program.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 2, 1987

Mr. OBERSTAR introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To provide a transition period for the full implementation of the nonrecurring adoption expenses reimbursement program.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TRANSITION PERIOD FOR FULL IMPLEMENTATION OF NONRECURRING ADOPTION EXPENSES REIMBURSEMENT PROGRAM.

(a) IN GENERAL.—Section 151 of the Tax Reform Act of 1986 (relating to effective dates) is amended by adding at the end thereof the following new subsection:

"(f) ADOPTION EXPENSES.—

"(1) IN GENERAL.—The amendments made by section 135 shall apply to taxable years beginning after December 31 of the calendar year in which final regulations are issued to implement the reimbursement of nonrecurring adoption expenses under any adoption assistance agreement under subtitle E of title IV of the Social Security Act.

"(2) DENIAL OF DOUBLE BENEFIT.—No deduction shall be allowed with respect to amounts paid for adoption expenses directly related to the legal adoption of a child with special needs under section 222 of the Internal Revenue Code of 1986 to any taxpayer receiving reimbursement for such amounts under any adoption assistance agreement under subtitle E of title IV of the Social Security Act.".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect as if included in section 151 of the Tax Reform Act of 1986.

Section 142

Statement of a Coalition
of Maritime Companies and
Associations to the
Committee on Ways and Means,
U.S. House of Representatives
re
H.R. 2636, The Technical Corrections Act of 1987

The associations and companies listed at the end of this statement submit the comments in the paragraphs following concerning The Technical Corrections Act of 1987 and a proposal to amend it.

The Tax Reform Act of 1986 reduces the deduction available to employers for the cost of meals provided to employees, as well as other meals considered ordinary and necessary business expenses, from 100% to 80%. Unfortunately, the IRS is applying this rule to meals being provided to crews of merchant vessels and offshore drilling rigs. Such a broad application of the 80% rule leads to the completely inequitable result that meals provided to such crews are treated just like other "business meals," including the infamous "three martini lunch," and "entertainment."

Meals provided to crews of vessels and drilling rigs are entirely different from other "business meals." They are not extravagant or lavish. They are the furthest thing from "entertainment" as defined in the Internal Revenue Code. And they are an absolutely essential aspect of operating vessels and drilling rigs.

The 100% deductibility of the cost of meals provided to crews of vessels and offshore drilling rigs should therefore be restored In particular, such full deductibility should be restored because:

- It is a legal requirement to provide meals to merchant seamen. This federal law requirement dates back at least to 1872 and is backed by civil and criminal penalties. Owners and operators of drilling rigs are obligated by contracts to provide meals to crew members;
- As a practical necessity, due to physical isolation, meals must be provided by employers to crews on vessels and drilling rigs;
- The penalty to vessel and drilling rig owners and operators is particularly unfair because meals provided to crew members must be provided at a high cost;
- Provision of meals to crew members of vessels and drilling rigs is just as essential an aspect of doing business as lifejackets for those same crew members which are fully deductible;
- 80% deductibility is directly contrary to the purposes of various statutes making it a national policy to enhance the strength and competitiveness of our merchant marine;
- Meals provided to the crews of vessels and rigs are even more necessary and reasonable than meals exempted under the Tax Reform Act from the 80% deductibility requirement. For example, meals provided by restaurants and caterers to their employees are fully deductible; and
- Revenue to the Treasury from the 80% rule would be de minimis. It is estimated that less than $15 million would be paid in additional taxes if the 80% rule is applied to meals provided to vessel crews and to personnel on drilling rigs.

Restoring 100% deductibility to meals provided to crews of vessels and drilling rigs is necessary to prevent an unwarranted hardship to two of America's most vital industries. The unique nature of the provision of meals to crew members by those industries should be recognized and distinguished in the Internal Revenue Code.

Proposed Amendment

It is recommended that the following proposed amendment to The Technical Corrections Act of 1987 be adopted:

Paragraph (2) of section 274(n) (relating to exceptions to the 80% limitation on deductibility of business meals) is amended by adding the following new subparagraph:

> "(E) such expense related to food and beverages provided to a qualified recipient."

Section 274(n) is further amended by adding new paragraph (4) to read as follows:

> "(4) QUALIFIED RECIPIENT - For purposes of paragraph (2) (E), the term "qualified recipient" means any person who receives food and beverages while performing services for an employer either --
>
> (A) aboard a commercial vessel as a crew member or officer;
>
> (B) aboard an oil or gas drilling rig located offshore or in Alaska; or
>
> (C) in a remote location where satisfactory meals are not available on the open market; but only if such food and beverages are furnished in a common area which is --
>
> (i) located, as near as practible, in the vicinity of the place at which such individual renders services, and
>
> (ii) not available to the public and normally accommodates 10 or more employees."

Technical Explanation of Amendments to Section 274(n)

Section 274(n) provides that, as a general rule, only 80% of the cost of business meals are deductible. Paragraph (2) of section 274(n) contains certain exceptions to this general limitation on the deductibility of business meals. The proposed amendment adds an additional exception to the general rule for meals provided to crew members of commercial vessels, to employees working on certain drilling rigs, and to employees furnishing services at remote locations.

Under the proposed amendment, employers may deduct the full cost of meals provided to persons while they are performing services for an employer either (1) aboard a commercial vessel as a crew member, (2) aboard an oil or gas drilling rig located offshore or in Alaska or (3) in a geographically remote location. To qualify under the third prong of the proposed exception, limitations patterned after those set forth in section 119(c) must be satisfied. Thus, "remoteness" is tested under the amendment by reference to whether satisfactory meals are available on the open market. In addition, the place where the meals are provided must be located near the job site, not be available to the public, and must normally accommodate 10 or more employees.

Enclosed is a memorandum describing the statutory requirement that meals be provided to vessel crews.

This statement is submitted in the name of:

AMERICAN COMMERCIAL BARGE LINE COMPANY (ACBL)
AMERICAN INSTITUTE OF MERCHANT SHIPPING (AIMS)
AMERICAN WATERWAYS OPERATORS, INC. (AWO)
COUNCIL OF AMERICAN FLAG-SHIP OPERATORS (CASO)
INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS (IADC)
INTERNATIONAL ASSOCIATION OF GEOPHYSICAL CONTRACTORS (IAGC)
CROWLEY MARITIME CORPORATION
MATSON NAVIGATION COMPANY
NATIONAL OCEAN INDUSTRIES ASSOCIATION (NOIA)
SEA-LAND CORPORATION
TOTEM OCEAN TRAILER EXPRESS (TOTE)
TRANSPORTATION INSTITUTE (TI)

By:

Jack M. Park

Jack M. Park
Vice President
Governmental Relations

MEMORANDUM

Re: THE 80 PERCENT LIMIT ON DEDUCTIONS FOR BUSINESS MEALS SHOULD NOT APPLY TO MEALS PROVIDED TO MERCHANT SEAMEN

SUMMARY.

As interpreted by the Internal Revenue Service, the Tax Reform Act of 1986 reduces the deduction available to owners and operators of vessels for the cost of meals provided to merchant seamen from 100 to 80 percent. Meals provided to merchant seamen were fully deductible prior to the Tax Reform Act. Limiting this deduction now fails to take into account the unique circumstances under which meals are provided to merchant seamen which are totally unlike those of the typical "business meal," or the common type of meal provided by an employer to an employee. In particular, such a limitation fails to take into account that as a practical and legal matter, meals _must be_ provided to merchant seamen by owners and operators of U.S. flag vessels. Meals for merchant seamen are just as necessary an expense as are lifejackets for those same seamen, and fuel for the vessel, all of which are required before any vessel can go to sea. Meals provided to merchant seamen onboard vessels should therefore be exempted from the 80 percent limit on deductibility.

THE PERCENTAGE REDUCTION RULE.

Section 162 of the Internal Revenue Code provides for a deduction for all "ordinary and necessary" expenses paid or incurred by a taxpayer during the taxable year in carrying on a trade or business. 26 U.S.C. §162. An expense is "ordinary" if it is of the type frequently incurred by the taxpayer in his particular trade or business. An expense is "necessary" if it is appropriate or helpful to the taxpayer's business. An expense that is ordinary and necessary must also be reasonable; to the extent an expense is unreasonable, it is not necessary and will be disallowed as a deduction.

A new exception to the rule that ordinary and necessary business expenses are fully deductible was created by the Tax Reform Act of 1986 which reduced the amount which can be deducted from 100 to 80 percent for business meals, entertainment and travel. Pub. L. No. 99-514, §142, _codified as_ 26 U.S.C. §274 (n). Section 142 of the Tax Reform Act provides that:

> The amount allowable as a deduction under this chapter for . . . any expense for food or beverages . . . shall not exceed 80 percent of the amount of such expense or item which would (but for this paragraph) be allowable as a deduction under this chapter.

Section 142 of the Act contains several exceptions to the percentage reduction rule. For instance, the expenses of food and beverages incurred as an integral part of a convention, seminar or other "qualified meeting" are fully deductible. 26 U.S.C. §274 (n)(2)(D). The percentage reduction rule also does not apply to a restaurant or catering firm "which may deduct 100 percent . . . of its costs for food and beverage items, purchased in connection with preparing and providing meals to its paying customers, that are consumed at the work site by employees of the restaurant or caterer." House Conf. Rept. No.

99-841, II-25. No justification for these exceptions is provided either in the Tax Reform Act or in its legislative history.

Since, however, there is no similar expense exception for seamen's meals, the Internal Revenue Service is taking the position that these crew meals are in the same category as business meals and entertainment expenses and therefore subject to the percentage reduction rule.

UNIQUE NATURE OF CREW'S MEALS.

The meals in question are unique in several respects and cannot be compared to what is usually thought of as "business meals" or "entertainment." Both as a practical and as a legal matter, meals must be provided to merchant seamen on board vessels at sea. As a practical matter meals must be provided because of the physical isolation of vessels at sea. This isolation requires vessels to be self-contained in terms of fuel, food, water and other consummables. For the same reason the crew is limited to obtaining meals on board the vessel supplied by the vessel owner or operator since it is without question infeasible to feed the crew in any other way.

In addition to being the only practical source of crew meals, U.S. law requires vessel owners and operators to provide meals to their crews which alone makes these meals unique when considering that which the Tax Reform Act was intended to cover.

These statutory requirements that meals be provided to vessel crews are long-standing. At least as early as 1872 vessels with inadequate provisions were considered unseaworthy with serious legal ramifications. Act June 7, 1872, ch. 322, §36, 17 Stat. 269, codified as 46 U.S.C. §10902. As currently codified, the 1872 statute provides that "[a]ny 3 seamen of a vessel may complain that the provisions of food or water for the crew are, at any time, of bad quality, unfit for use, or deficient in quantity." 46 U.S.C. §10902(b)(1). If such complaint is found to have merit by the Coast Guard or local consul, the master of the vessel would be civilly liable. 46 U.S.C. §10902(b).

Later Congress went further and made it a criminal offense to withhold suitable food and nourishment from seamen. Act Dec. 21, 1898, ch. 28, §22, 30 Stat. 761, codified as 18 U.S.C. §2191. Section 2191 of title 18 provides:

> Whoever, being the master or officer of a vessel of the United States, on the high seas, or on any other waters within the admiralty and maritime jurisdiction of the United States . . . withholds from the . . . [crew] suitable food and nourishment, . . . shall be fined not more than $1,000 or imprisoned not more than five years, or both.

Congress also provided for civil liabiliity for the master or owner for the failure to provide "sufficient quantity of stores to last for a voyage of ordinary duration." Act Dec. 21, 1898, ch. 28, §12, 30 Stat. 758 (codified as 46 U.S.C. §661 until 1983). And Congress mandated in detail what provisions had to be provided at a minimum. Act Dec. 21, 1898, ch. 28, §23, 30 Stat. 762 (codified as 46 U.S.C. §713 until 1983). For example, the following substitutes were some of the ones allowed:

> One pound of flour daily may be substituted for the daily ration of biscuit or fresh bread; two ounces of desiccated vegetables for one pound of potatoes or yams; six ounces of hominy, oatmeal, or cracked wheat, or two ounces of tapioca, for six ounces of rice.

As a result of the revision of Title 46 of the U.S. Code in 1983, Pub. L. No. 98-89, 97 Stat. 100, many of the anachronisms of the previous acts protecting seamen were eliminated, but the legislated mandate that seamen be provided meals remains. Seamen currently employed on vessels involved in foreign and intercoastal voyages "shall be served at least 3 meals a day that total at least 3,100 calories, including adequate water and adequate protein, vitamins, and minerals in accordance with the United States Recommended Daily Allowances." 46 U.S.C. §10303. The same requirement applies to vessels involved in coastwise voyages when a crew is engaged by a shipping commissioner. 46 U.S.C. §10507(b). Most importantly, regardless of the type of voyage, it remains a criminal offense punishable by fine and imprisonment to withhold suitable food and nourishment to seamen, 18 U.S.C. §2191; 46 U.S.C. §11507, and a vessel with insufficient provisions is still considered unseaworthy. 46 U.S.C. §10902. In this respect these meals are the same as providing lifejackets to the crew, also mandated by law but fully deductible.

THE PERCENTAGE REDUCTION RULE SHOULD NOT APPLY TO MEALS PROVIDED TO MERCHANT SEAMEN.

The "necessity" of providing meals to vessel crew members, which is reflected in and made even more "necessary" by law providing civil and criminal sanctions, places those expenses in the same class as other ordinary and necessary vessel operating expenses such as fuel and wages. These meals are therefore distinguishable from the type of lunches and dinners contemplated by the new limitations, indeed, they are even more "ordinary and necessary" than the restaurant/caterer employee meals and convention meals which are excepted from the limitations.

The typical meal provided by an employer to an employee, even if it is a "necessary" business expense, is still not a physical and legal necessity like a meal provided to merchant seamen on board a vessel at sea. The ordinary business meal provided by an employer to an employee involves at least some measure of choice. The employer has the choice, for example, whether to operate a cafeteria for its employees, and the employee has the choice whether to eat in the cafeteria. These same choices are available to convention organizers and attendees, and restaurant owners and employees who are not subject to the limitations. The owners and operators of merchant vessels and their crews have no such choices.

CONCLUSION.

Since meals provided to merchant seamen are no different than other ordinary and necessary vessel operating expenses which are fully deductible, and since such meals are in several compelling ways different from the typical business meal and other meals customarily provided by employers to employees, the percentage reduction rule should not apply to them. To do otherwise would fail to recognize the uniqueness of the legally mandated and essential provision of meals to merchant seamen and subject the maritime industry to an injustice not intended by Congress.

IVINS, PHILLIPS & BARKER
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INTERNATIONAL TELEX NUMBER
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July 27, 1987

Mr. Robert J. Leonard
Chief Counsel
House Ways and Means Committee
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Technical Corrections - Moving Meal Expenses

Dear Rob:

We represent the Employee Relocation Council (E-R-C). E-R-C is a trade association of over 1,000 major companies which, on a regular basis, must address the problems of employee relocation. Over 60% of the Fortune 1000 corporations are E-R-C members.

We have recently identified a problem that we believe must be addressed in the pending technical corrections bill. It is a problem that is not, we believe, susceptible of solution through regulations or proper planning.

The problem results from the interaction of the new 80% limitation on deductibility of meal expenses (Code §274(n), added by the 1986 Act), the exceptions to that limitation (specifically, §274(e)(2)) and the existing exceptions from the definition of wages for withholding purposes (specifically, §3401(a)(15)).

The problem arises when an employer reimburses an employee for a meal expense incurred in connection with a move that qualifies under §217. Section 274(e) must be consulted to determine whether the employer or the employee bears the burden of the 80% limitation on the deduction. Because §82 requires that reimbursements of moving expenses be included in an employee's gross income as compensation for services, the answer to the question as to whether the employee or the employer bears the 80% limitation depends upon the application of the last clause of §274(e)(2), i.e., whether the reimbursed moving meal expense is also treated as wages for purposes of Chapter 24 relating to withholding of income tax. If the reimbursed meal expenses are treated as wages subject to withholding, §274(e)(2) excepts the employer from the 80% limitation and the employee will bear it. If the reimbursement is not treated as withholdable wages, then the employer must bear that limit since §274(e)(2) would not be applicable.

Unfortunately, the question as to whether the employer treats the reimbursement as wages subject to withholding depends upon the extent to which the reimbursement is deductible under §217. Since the deduction for a moving meal expense under §217 is limited by §274(n) (and the exceptions under §274(e)(2)), the extent of deductibility (i.e., 80% or 100%) under §217 itself depends upon whether the reimbursement is treated as wages for withholding purposes.

Obviously, the provisions are circular. The moving meal reimbursement is excluded from wages for withholding purposes to the extent that it is deductible by the employee (§3401(a)(15)), but the extent (i.e., 80% or 100%) of its deductibility depends on whether or not it is treated as wages.

Because of the complexity of the interaction of the various provisions of §274, we believe the simplest and cleanest solution would be an amendment to §3401(a)(15) along the following lines:

> Amend ¶15 of Subsection (a) of Section 3401 to read, in its entirety, as follows:
>
> "(15) To or on behalf of an employee if (and to the extent that) at the time of the payment of such remuneration it is reasonable to believe that a corresponding deduction is allowable under §217 (computed without reference to §274(n)); or"

Under this solution, except to the extent a moving meal expense exceeds a §217 dollar limit, it would not be withheld against and the employer would bear the 80% limit. No underwithholding would occur since the employee would be relieved from the 80% limit under §274(e)(3). This solution is also simpler than interrupting the circle with the initial (and incorrect) assumption that 80% of the meal expense will be deductible by the employee.

We believe that it should be beyond argument that this amendment is "technical." It is required to resolve a circularity created in the Code by the 1986 Act which makes impossible the application of two provisions. It would have been justified as part of the 1986 Act as a conforming amendment necessary to make §274(n) work properly in the moving meal expense context. It raises no policy issues that we know of. As far as we can see, it neither benefits nor hurts either the Treasury or taxpayers.

We would appreciate the opportunity to meet with or speak by telephone with the appropriate person on your staff to handle this problem. While it may appear a small matter, it is important to remember that there are at least 500,000 employee relocations every year where employers will reimburse meal expenses (out of the more than 1.5 million moves generating §217 deductions). This issue will be present in the reporting of every one of these moves. We trust that you will agree that an amendment to the technical correction bill is warranted to resolve this problem.

Sincerely,

Philip D. Morrison

NATIONAL ASSOCIATION OF ROYALTY OWNERS (NARO)
WRITTEN COMMENTS ON H.R. 2636
TECHNICAL CORRECTIONS ACT OF 1987

Mr. Chairman and members of the House Ways and Means Committee, NARO makes its comment on one provision of the Tax Reform Act of 1986, subsection 142(c), which amended section 274(h) of the Internal Revenue Code.

Subsection 142(c) of TRA '86 amends Subsection 274(h) of the Code by disallowing any deduction under Section 212 of the Code for conventions, seminars, or similar meetings. Section 212 of the Code allows deductions related to expenses incurred "for the management, conservation, or maintenance of property held for the production of income", among other things.

It is under Code section 212 provision that oil and gas royalty owners take deductions related to expenses arising from their ownership of royalty property.

The House Ways and Means Committee Report explained subsection 142(c) of TRA 86 as follows:

> The committee is concerned about deductions claimed for travel and other costs of attending conventions or other meetings that relate to financial or tax planning of investors, rather than to a trade or business of the taxpayer. For example, individuals claim deductions for attending seminars about investments in securities or tax shelters. In many cases, these seminars are held in locations (including some that are overseas) that are attractive for vacation purposes, and are structured so as to permit extensive leisure activities on the part of attendees.
>
> Since investment purposes do not relate to the taxpayer's means of earning a livelihood (i.e., a trade or business), the committee believes that these abuses, along with the personal living expenses, justify denial of any deduction for the costs of attending a non-business seminar or similar meeting that does not relate to a trade or business of the taxpayer.

There are numerous differences between the perceived abuse and the actual NARO situation:

1. Naro meetings are not held in exotic locations. Most people do not consider Dallas, Oklahoma City, Austin or Tulsa as prime resort areas (certainly not compared with cruises or trips to California, Florida or Hawaii.)

2. Hotels in these cities are not chosen because of their luxury accommodations, but because they extend reasonable package prices and thus allow as many members as possible to attend the meetings.

3. Informative daily sessions are scheduled from early morning breakfast meetings until 4:00 to 5:00 p.m., leaving little or no time for sight-seeing.

4. The management of mineral/royalty interests has become more complex than just depositing checks into a bank account. The seminars, panels, and discussions are not directed at how to postpone or delay payment of income tax, but are directed at keeping members informed of how to receive income upon which to pay taxes.

5. Meetings are planned for and information is presented, not for the wealthy, but for people who receive minimum income.

6. NARO meetings and seminars allow people from across the United States to meet, share ideas, and hear technical sessions on managing their mineral/royalty interests. For those who do not live in the oil and gas producing states, NARO is often their only available source of information in learning about their assets and source of income.

7. Individuals who own working interests (and report their income and deductions on Schedule C) will be allowed to continue deducting "convention expenses", while those who receive royalty income will be denied the deduction. Given two individuals with an interest in the same well (one a working interest and the other a royalty), it seems highly inequitable for the former to be allowed a deduction, while the latter is denied the same.

It is point number 7 that NARO believes justifies classifying an amendment to Code section 274(h) a technical amendment. In TRA 86, Congress did not eliminate the deduction for attending a NARO convention or meeting for people with high incomes from royalty property (managing their royalty properties may be their trade or business); oil and gas lawyers; accountants; oil and gas landmen; bank officers; oil company executives; independent producers with royalty interests, and so on. So the impact of TRA 86 on royalty owners who are elderly, middle to low income, or widows is greater than other potential NARO convention attendees.

Therefore, although the application of Subsection 142(c) of TRA 86 to certain oil and gas royalty owners may not be because of a drafting "glitch" in TRA 86, the application is surely an unintentional oversight.

NARO proposes that Code section 274(h) be amended as follows (new words underlined):

> "(c) Seminars, Etc. for Section 212 Purposes - No deduction will be allowed under section 212 for expenses allocable to a convention seminar, or similar meeting unless the deduction would be allowed under Code section 62(1) as a trade or business deduction attributable to royalty income."

OR

> "(c) Seminars, Etc. for Section 212 Purposes - No deduction will be allowed under section 212 for expenses allocable to a convention seminar, or similar meeting unless the deduction would be allowed under Code section 62(1) as a trade or business deduction attributable to royalty income; and the convention, seminar or similar meeting is sponsored by an organization described in Section 501(c)6."

NARO appreciates the Committee's consideration of its position and respectfully requests that the amendment suggested be added to H.R. 2636.

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Congreſs of the United States
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Washington, DC 20515

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SURFACE TRANSPORTATION
WATER RESOURCES

SELECT COMMITTEE ON
NARCOTICS ABUSE AND CONTROL

July 15, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 Rayburn H.O.B.
Washington, D.C. 20515

Dear Dan:

I am writing to let you know of a provision in the Tax Reform Act of 1986, which is also contained in H.R. 2636, the Technical Corrections Act of 1987, that concerns me.

Section 142 of the Tax Reform Act reduces the deduction available of certain business meals from 100% to 80%. I certainly understand the reasoning behind the percentage reduction rule -- to limit the abuse of lavish meals at the expense of the taxpayer. However, the Internal Revenue Service has interpreted this provision to apply the reduction to the meals being provided to crews of merchant vessels.

The circumstances surrounding the meals for merchant seamen are quite unique. Although I have not had the pleasure of enjoying a meal on a merchant vessel, I have been assured by those who have, that the meal was certainly not lavish under any circumstances. Therefore, these meals can in no way be compared to a typical "three martini lunch."

Furthermore, under current law, meals are required to be provided to crew members on board vessels at sea. Failure to provide such meals, or to withold suitable food and nourishment from seamen is a criminal offense punishable by fine and imprisonment, 18 U.S.C. § 2191; U.S.C. § 11507.

For your information, I am enclosing a copy of a letter from Hvide Shipping Incorporated, which is located in my district in Fort Lauderdale, Florida. This letter reveals the difference between a lavish meal and a "necessary" one that they provide to their crew.

I certainly hope that the Committee would consider the unique nature of merchant vessels, who are required by one law to provide meals, and are not allowed to deduct them in full as a business expense by another law.

For this reason, I would certainly support an amendment to the Technical Corrections Bill which would restore the 100% deductibility to meals provided to crews of vessels.

I appreciate your concern in this matter.

Sincerely,

Clay

E. Clay Shaw, Jr.
Member of Congress

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INCORPORATED

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July 9, 1987

Representative Dan Rostenkowski
Chairman House & Ways Committee
2111 RHOB
Washington, D.C. 20515-1308

Dear Representative Rostenkowski:

As you are aware, the Tax Reform Act of 1986 reduced the income tax deductibility of certain business meals from 100% to 80%. This change was made in part to respond to public concern about the perceived abuse of certain business meals and the propriety of taxpayers subsidizing them. We were shocked, however, to discover that the statute apparently will require reduced deductibility of meals provided to our shipboard officers and crew assigned to our tanker fleet and harbor tugboats. It is inconceivable that the intent of this legislation was to penalize employers who are required by necessity to provide basic subsistence to their employees stationed aboard vessels which are operating far from shore. This legislation was intended to reduce the subsidizing of $50, "3 martini lunches" at 5-star restaurants, not basic subsistence which, in our case and in the case of most of those in our industry, averages less than $10 per man per day. These costs are expended not for Chateaubriand and caviar at the 21 Club, but rather for meatloaf, mashed potatoes and corn on the cob served in the confines of a 12' by 12' galley. This, clearly, is not taxpayer abuse.

In order to rectify this inequity we strongly suggest that the Technical Corrections Bill presently being discussed by Congress include a provision which would exclude application of the 80% rule for meals served aboard U.S. Flag commercial vessels (other than passenger ships) provided that the average cost does not exceed $15 per man per day.

A provision such as that indicated above would properly recognize the distinction between meals and entertainment which are sometimes lavish and arbitrary and those which are nothing more than common subsistence for employees who are provided meals at their place of work for which there is no other alternative. Please give this matter your utmost consideration.

Sincerely,

AFFILIATES: PORT EVERGLADES TOWING • HVIDE MARINE INTERNATIONAL, INC.
HVIDE MARINE SERVICES, INC. • SEABULK CORPORATION • SEABULK TANKERS, LTD. • SEABULK CHEMICAL CARRIERS, INC.
SEABULK TRANSMARINE I, INC. • SEABULK TRANSMARINE II, INC. • SEABULK TRANSMARINE III, INC.

Title II, Section 201

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FILE NO.

DIRECT DIAL NO. 804 788 8676

July 16, 1987

FEDERAL EXPRESS

Robert J. Leonard, Esq.
Chief Counsel
House Ways and Means Committee
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Washington, D.C. 20515-6348

Section 102(a)(7)(E) of H.R. 2636

Dear Rob:

I want to bring to your attention a point in reference to the proposed technical correction to I.R.C. section 168(i)(7) contained in the above-referenced section of the Technical Corrections Bill. The technical correction makes it clear that any transaction "between members of the same affiliated group during any taxable year for which a consolidated return is made by such group" is a transaction described in subparagraph (B) of section 168(i)(7) to which subparagraph (A) of section 168(i)(7) is applicable. Section 168(i)(7) also provides, however, that subparagraph (A) of section 168(i)(7) shall not apply in the case of a termination of a partnership under section 708(b)(1)(B).

The point relates to a partnership that is wholly-owned by two or more corporations who are members of the same affiliated group during any taxable year for which a consolidated return is made by such group. A transaction between members with respect to the partnership interests held by one or more of such members that results in a tax termination of the partnership under section 708(b)(1)(B) also should be included within the group of transactions to which subparagraph (A) of section 168(i)(7) applies. Thus, the rule applicable to transactions between members of the same affiliated group should override the rule relating to terminations of partnerships.

I will be happy to discuss this matter with you or anyone on your staff at your or their convenience.

With best regards.

Sincerely yours,

B. Cary Tolley, III

Section 203

July 24, 1987

Robert J. Leonard
Chief Council
Committee on Ways and Means
1102 Longworth House Office Bldg.
Washington, D.C. 20515

HAND DELIVERED

RE: Technical Corrections Act S102(c)(2)
mid-quarter convention- operation of 40% test

Dear Mr. Leonard:

Taxpayers including several equipment lessors already have placed certain property in service early in 1987 so as to avoid the operation of the mid-quarter convention for depreciation. The Technical Corrections Act S102(c)(2) would radically alter the operation of the 40% test that triggers application of the mid-quarter convention. We respectfully request that S102(c)(2) of the bill be deleted or modified, as explained in the attached memorandum, to avoid unfairness to these taxpayers and prevent disruption of the business community.

Thank you for considering our views on this important technical issue.

Yours very truly,

Michael J. Fleming, CAE
President, AAEL

MEMORANDUM

Re: Technical Corrections Act of 1987 §102(c)(2):
mid-quarter convention- operation of 40% test

Technical Corrections Act §102(c)(2) (H.R.2636 and S.1350), if enacted, would radically alter the operation of the 40 percent test that triggers application of the mid-quarter convention in the depreciation rules. This memorandum by the American Association of Equipment Lessors (AAEL) respectfully requests that proposed §102(c)(2) be modified or deleted.

Ordinarily, under the Tax Reform Act of 1986, a half-year convention applies to first year and last-year allowances for depreciable personal property. Yet under Code §168(d)(3), if a taxpayer in any taxable year places more than 40% of its applicable property in service in the last quarter, a mid-quarter convention will apply to determine the cost-recovery allowances for all such property. This mid-quarter convention treats all property placed in service during any quarter of a taxable year as placed in service on the midpoint of such quarter. Section 203(d)(3) of the 1986 Act contains a special rule that requires the taxpayer to take transition ACRS property into account in applying the 40% test. If the mid-quarter convention applies, however, it applies only with respect to new law property. The mid-quarter convention does not apply to reduce the depreciation on transition ACRS property. See H.R.(Conf) Rept.99-841 p.II-47 (1986).

The technical correction proposed in §102(c)(2) of the bill would eliminate transition ACRS property from the 40% calculation for taxable years beginning on or after January 1, 1987. The statutory language from §203(d) of the Tax Reform Act of 1986, with underscored language showing the proposed technical amendment, is this:

> "(d) MID-QUARTER CONVENTION.-- In the case of any taxable year beginning before 1987 in which property to which the amendments made by section 201 do not apply is placed in service, such property shall be taken into account in determining whether section 168(d)(3) of the Internal Revenue Code of 1986 (as amended by section 201) applies for such taxable year to property to which such amendments apply. The preceding sentence shall apply only to property which would be taken into account if such amendments did apply."

The only purpose of this proposed technical amendment, apparently, is to clarify the application of the mid-quarter convention to certain elective property placed in service during the last 5 months of 1986. *See* Joint Committee on Taxation's "Description of the Technical Corrections Act of 1987" p.12 (June 15, 1987). But the proposed technical amendment also has other harsh (and possibly unintended) effects.

Two examples illustrate the impact of the proposed technical amendment that concerns us.

> *Example 1*. A calendar year taxpayer places $70 of transition ACRS property in service in January 1987 and places $30 of new law property in service in November 1987. Under existing law the mid-quarter convention does not apply to any of this property. Technical Corrections Act §102(c)(2) would cause the mid-quarter convention to apply to the new law property.
>
> *Example 2*. A calendar year taxpayer places $30 of new law property in service in January 1987 and places $70 of transition ACRS property in service in November 1987. Under existing law the mid-quarter convention applies to the new law property. Technical Correction Act §102(c)-(2) would cause the mid-quarter convention to be inapplicable.

The outcome illustrated by Example 1, under the proposed technical amendment, would unfairly penalize taxpayers (including several equipment leasing companies) who already have placed transition ACRS property in service. Relying on current law, these taxpayers placed such property in service early in 1987, and made commitments and plans to place some new property in service late in 1987, with the reasonable expectation of avoiding the mid-quarter convention. The outcome illustrated by Example 2 also penalizes the taxpayer who made deliveries, commitments and plans for placed-in-service dates in reasonable reliance on current law, since depreciation on the new law property already placed in service in January 1987 (which would qualify for 10½ months depreciation under existing law) would be cut back to 6 months under the proposed technical amendment. Moreover, as illustrated by both Example 1 and Example 2, the change of law threatened by the technical amendment (and the uncertainty created by this threatened change) are disruptive to reasonable tax planning by businessmen.

To avoid this sort of unfairness and disruption, AAEL suggests that §102(c)(2) of the technical corrections bill be deleted. Alternatively, proposed §102(c)(2) might to changed so that it applied only in "the case of any taxable year beginning before 1989" (instead of 1987), so as to give taxpayers time to adjust their scheduled placed-in-service dates to the new proposed law.

July 25, 1987

July 17, 1987

Robert J. Leonard, Esq.
Chief Counsel, Committee on
Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

In accordance with the announcement (Press Release #15) by Chairman Rostenkowski extending the period for submitting comments on H.R 2636 (the "Technical Corrections Act of 1987"), we hereby submit comments on behalf of Resorts International, Inc. These comments are directed to clarification of the transitional rules for depreciation and investment tax credits provided in the Tax Reform Act of 1986, and in particular at conflicts of interpretation in the legislative history of those transitional rules.

FACTS AS TO THE RESORTS INTERNATIONAL HOTEL PROJECT IN ATLANTIC CITY, NEW JERSEY

In October, 1976, Resorts International, Inc. entered into a contract with the Housing Authority of the City of Atlantic City (HACAC) pursuant to which the HACAC agreed to convey to Resorts title to a certain tract of land, in return for which Resorts agreed to construct and complete a 1,000 room resort hotel and ancillary facilities and also agreed to pay $5.6 million for the land. Under the federal income tax laws then in effect, Resorts expected to depreciate both real property improvements and personal property based on the rules then in existence and to obtain investment tax credits on the cost of the personal property.

Due to litigation involving adverse title claims against the property, HACAC was delayed in providing the clear title called for under the contract. However, plans for the hotel were submitted to the appropriate authorities and approved in 1982, and construction actually commenced in October, 1983. It is estimated that the hotel will open its doors for business in the first quarter of 1988.

SUMMARY OF LEGISLATIVE HISTORY

The Tax Reform Act of 1986 made certain changes relating to depreciation and eliminated the investment tax credit. In an effort to grandfather projects which commenced prior to enactment of the Act, certain transitional rules were adopted, including the "equipped building" rule (see section 203(b)(1)(C) of the Act). The equipped building rule provides that where a taxpayer has incurred or committed at least 50% or more of the total cost of an equipped building prior to January 1, 1986, it will be permitted to utilize the pre-1986 depreciation ACRS guidelines and may take investment tax credits on property, including furniture, fixtures and equipment, ordered after December 31, 1985.

The application of this transitional rule turns on the meaning of the words "incurred or committed." The Conference Report indicates in an example that "incurred or committed" includes commitments under a "written binding contract." There is a difference of opinion between Senators Moynihan and Packwood (then Chairman) of the Senate Finance Committee, on the one hand, and Congressman Rostenkowski, Chairman of the House Ways and Means Committee, on the other hand, as to the meaning of a "written binding contract" in this context. The Senators in a colloquy on September 27, 1986 concluded that the term includes contracts with municipal authorities. Congressman Rostenkowski, in a response on October 2, 1986, stated that it means only a binding contract between the taxpayer and a contractor, sub-contractor or supplier, and does not include a contract with a municipal authority.

Senator Packwood in a subsequent statement of October 17, 1986 reiterated and emphasized his prior view, pointing out that the severe limitation proposed by Congressman Rostenkowski has no basis in the Statement of Managers and that the rule is not limited as Congressman Rostenkowski stated.

CLARIFICATION SOUGHT

In view of this conflict of interpretations by the principal Congressional sponsors of the Tax Reform Act, it seems appropriate and desirable to eliminate the confusion and provide clarification in the proposed Technical Corrections Act. We believe there is merit to the position taken by Senators Moynihan and Packwood where a taxpayer, such as Resorts International, entered into firm contractual commitments in reliance on the law then in effect, long before any consideration was given to the kind of changes made in the Tax Reform Act of 1986.

In this regard, we suggest that the Technical Corrections Act provide a definition of a written binding contract to include "contracts between the taxpayer and a contractor, sub-contractor, supplier or a municipal authority (if such contract with a municipal authority was entered into prior to January 1, 1985)."

We will be glad to provide the Committee with any additional information or details which it may require, or to respond to questions.

Sincerely yours,

John Antholis by

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FILE NO

DIRECT DIAL NO 804 788 8676

July 16, 1987

FEDERAL EXPRESS

Robert J. Leonard, Esq.
Chief Counsel
House Ways and Means Committee
Longworth House Office Building
Room 1102
Washington, D.C. 20515-6348

H.R. 2636--Technical Corrections Act of 1987
Comments Relating to I.R.C. Section 168(d)(3)

Dear Rob:

I am writing in response to the Committee's request for comments on H.R. 2636--Technical Corrections Act of 1987 (the "1987 Act"). The following comments concern a need for clarification on the treatment of non-ACRS property in connection with the mid-quarter convention in I.R.C. section 168(d)(3).

Background. Section 168(d)(3) generally requires that a taxpayer use a mid-quarter convention for property placed in service during a taxable year if more than 40 percent of the property placed in service by the taxpayer during the year is placed in service during the last quarter of the year. The language of section 168(d)(3) provides that (1) the 40 percent determination is applied with respect to "property to which [section 168] applies" and (2) if a taxpayer is required to use the mid-quarter convention, the convention applies to "property to which [section 168] applies." A transition rule in section 203(d) of the Tax Reform Act of 1986 (the "1986 Act") requires that a taxpayer take into account, in making the 40 percent determination, property that is not subject to the amendments contained in section 201 of the 1986 Act. A technical correction in the 1987 Act clarifies (1) that the transition rule in section 203(d) applies only to taxable years beginning before 1987 and (2) that only property that is not subject to those amendments by virtue of the effective date or transition provisions of the 1986 Act is taken into account.

Need for Further Clarification. While the statute appears to exclude non-ACRS property (e.g., property that is involved in a churning transaction as described under section 168 before its amendment by the 1986 Act) from the 40 percent determination and application of the mid-quarter convention, the language in the legislative history to section 168(d)(3) causes some concern about that result. Specifically, the Joint Committee's General Explanation explains the 40 percent determination and mid-quarter convention as follows: "A mid-quarter convention is applied to all property if more than 40 percent of all depreciable property placed in service by a taxpayer during a taxable year is placed in service during the last three months of the taxable year." (Emphasis added.) The conference committee's report contains substantially identical language regarding the 40 percent determination.

The 1987 Act's proposed technical changes to section 203(d) of the 1986 Act, which are discussed above, clarify the issue materially. Nevertheless, the language in the legislative history to the 1987 Act should be supplemented to eliminate any uncertainty about whether the 40 percent determination and the mid-quarter convention apply to non-ACRS property. Such a supplement would be consistent with the language of section 168(d)(3) and section 203(d) of the 1986 Act, both as modified by the 1987 Act.

Proposed Language for Committee's Report. We recommend that the following language be added to the Committee's report for the 1987 Act:

> The Committee wishes to clarify that property not subject to ACRS (e.g., property that is excluded from ACRS because of a churning transaction) is not taken into account in making the 40 percent determination. Also, the mid-quarter convention would not apply to such property.

I will be happy to discuss this matter with you or anyone on your staff at your or their convenience.

With best regards.

Sincerely yours,

B. Cary Tolley

B. Cary Tolley, III

Section 204

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July 17, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Submission for the Record on H.R. 2636, the Technical Corrections Act of 1987

Dear Rob:

On behalf of our client, the Chrysler Corporation, I would like to take this opportunity to submit the following comment for the record on H.R. 2636, the Technical Corrections Act of 1987. It suggests a correction to the auto manufacturing facility investment tax credit transition rule that was intended to cover three Chrysler plants.

The Tax Reform Act of 1986 (Pub. L. No. 99-514) (the "Act") repealed the investment tax credit, effective generally for property placed in service after December 31, 1985. A number of transition rules were provided, however, for taxpayers who had substantially and reasonably relied on prior law in making investment decisions. Among those transition rules was one for certain auto manufacturing facilities that was intended to cover three plants owned and operated by the Chrysler Corporation (the "Company") in St. Louis, Missouri and Belvidere, Illinois (section 204(a)(5)(J)(ii)(II) of the Act).

As enacted by Congress, the auto manufacturing facility transition rule intended to apply to the Chrysler plants is defective in that the data used to identify the plants is incorrect. The Company submitted preliminary project data to assist the Joint Committee on Taxation in developing the scope of a revenue estimate for a generic auto manufacturing transition rule. This data had been subsequently refined prior to formal approval by the Company's Board of Directors, and therefore was not appropriate for use as a project identifier in the auto manufacturing plant specific rule approach ultimately adopted by the conferees. It should be noted that no facts or circumstances in the development of these three plants have changed since the enactment of the Act. The three projects that the conferees intended to cover remain the same three plants at the same locations producing the same cars that were described to the conferees. In fact, the Company's estimates indicate that the rule when corrected will have a federal revenue impact of approximately $7 million less than originally anticipated.

Therefore, in order to effectuate the Congressional intent underlying this rule, the Company respectfully requests that section 204(a)(5)(J)(ii)(II) be amended to read as follows:

> "(II) the Board of Directors of an automobile manufacturer approved a written plan for the conversion of [an] existing facilities to produce [a] new models of a vehicle not currently produced in the United States, such facilities will be placed in service by July 1, 1987, and such Board action occurred in July 1985, with respect to a [$523,000,000] $602,000,000 expenditure, [in June 1983, with respect to] a [$475,000,000] $438,000,000 expenditure, [or in July 1984, with respect to] and a [$312,000,000] $321,000,000 expenditure."

We appreciate this opportunity to comment on the technical corrections legislation and look forward to working with you and your staff on this issue.

Sincerely,

John J. Salmon

Attachment

SUMMARY OF SUBMISSION FOR THE RECORD OF
H.R. 2636 ON BEHALF OF
THE CHRYSLER CORPORATION

- The auto manufacturing facility transition rule intended to cover three Chrysler plants in St. Louis, Missouri and Belvidere, Illinois is defective in that the data used to identify the plants is incorrect.
- No facts or circumstances in the development of these three plants have changed since enactment of the Tax Reform Act of 1986. The three projects that the conferees intended to cover remain the same three plants at the same locations producing the same cars that were described to the conferees.
- In fact, the Chrysler Corporation's estimates indicate that the rule when corrected will have a federal revenue impact of approximately $7 million less than originally anticipated.

Respectfully submitted by:

John J. Salmon
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May
27th
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OUR FILE NUMBER
193,975-000

VIA MESSENGER

Janice Mays, Esq.
Majority Tax Counsel
Committee on Ways and Means
1111 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

We represent the Dulles Access Rapid Transit Corporation ("DART"), which is planning to construct a light rail commuter transit system running from the West Falls Church Metrorail station to Dulles International Airport. The project that DART plans to construct is the subject of transition rules under the Tax Reform Act of 1986, which continue to make available to the project ACRS and the investment tax credit. See section 204(a)(19) of the Conference Report. (This project is also the subject of a transition rule permitting the use of tax-exempt bonds to finance it. See section 1317(19)(A).) The purpose of this letter is to advise you of a technical correction DART is seeking to the transitional rule under section 204(a)(19). DART has been in contact with Senator Bentsen and his staff regarding this matter. Because the transitional rule in question originated in the Senate we felt it was appropriate to begin the process there. We believe things have moved to a point, however, where it is appropriate to bring the matter to your attention.

Section 202(b)(2) of the bill reported by the Senate Finance Committee provided that in order to be covered by the general transitional rule for ACRS the property in question must be placed in service by certain specified dates. This requirement did not extend to property covered by the specific transitional rules provided for in Section 202(d) of the bill. The bill was amended on the Senate floor, however, to make the placed in service requirement applicable, with certain modifications and exceptions, to projects covered by Section 202(d). As a result of the foregoing, the transitional rule for the DART project, which as noted above is in Section 204(a)(19) of the enacted legislation, is conditioned on the project being placed in service by January 1, 1991.

Significant steps have been taken toward the implementation of the DART project, but it is a very substantial undertaking that is greatly complicated by the need to obtain support of and approvals from several governmental and quasi-government entities. Consquently, it has been and remains very difficult to determine when the project will be completed, although DART is reasonably confident that it will be placed in service prior to January 1, 1993. Since enactment of the new tax law, DART has exerted considerable efforts toward the implementation of the project. The major effort has been devoted to negotiating with potential suppliers who would provide the rail system and would also be equity participants in the project. Members of DART's Board of Directors have conducted lengthy negotiations with three different suppliers and were on the verge of selecting one of them when they concluded that the final selection should be deferred until further progress has been made in pinning down the sublease of the right-of-way with the Metropolitan Washington Airports Authority, which was created in the last session of Congress to lease and operate National and Dulles Airports (including the Dulles Access Road and its median strip, which is the right-of-way DART needs) and only becomes operational this summer. It was felt that a better arrangement could be negotiated at that point. The important thing, however, is that the negotiations that were held clearly established the intent of the suppliers, their faith in the project and their willingness to commit substantial resources to it which will result in great savings to this public-service project.

DART has also been actively involved in generating public and political support for the project, and participated in a public hearing on rail transit in the Dulles corridor sponsored by Senators Warner and Trible and Congressman Wolf on March 31, 1987. In addition, as a result of local demand and intense interest by Fairfax and Loudoun County officials, DART has greatly expanded the scope and public service area of the program to include extensions from Dulles Airport southward eight miles to I-66 and thence eastward ten miles to complete the loop from Falls Church Metrorail station to Vienna Metrorail station.

DART believes strongly in the viability of its project and will continue its substantial efforts to make the project a reality, but it is now clear that the project will not be placed in service by January 1, 1991. Obviously, the transition rule was intended to benefit the project and Northern Virginia, as well as to assist in providing worldwide access to the principal gateway to the U.S. Capital, and we believe that because of the uncertainty as to whether that objective will be achieved if the required placed in service date is not changed, such a change is an appropriate technical correction and not a substantive one.

Thus, in order to insure that the transitional relief intended to be conferred is in fact realized, with little if any impact on revenues, we would ask that the applicable date be extended to January 1, 1993. DART had hoped that an extension to January 1, 1992 would be sufficient, but recent development cast doubt on the feasibility of that date. Various government officials have decided that a study of transportation alternatives in the Dulles corridor is necessary before any project can be approved. That study will probably not be completed until early to mid-1988. In addition, Virginia has just enacted legislation providing for transportation service districts, which can provide tax revenues to support transportation projects. It is very likely the DART project will require the establishment of such a district, but under this new legislation that will be a time consuming process because of the elaborate procedures that must be followed.

The requested change can be accomplished by adding the following sentence to the end of Section 204(a)(19):

> For purposes of this paragraph, Section 203(b)(2) shall be applied by substituting "January 1, 1993" for "January 1, 1991".

We appreciate greatly your consideration of this matter, and if we can provide you with further information, please do not hesitate to contact me.

Sincerely,

Ben E. Benjamin
of O'MELVENY & MYERS

BILL FRENZEL
THIRD DISTRICT, MINNESOTA

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Congreſs of the United States
House of Representatives
Washington, DC 20515-2303

July 17, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

I am writing to bring to your attention a transition rule that I support and would urge the Committee's favorable consideration. I am referring to a transition rule that would provide ITC transition relief for two projects currently under construction by Potlatch Corporation in Cloquet, Minnesota and Lewiston, Idaho.

H.R. 2636, the Technical Corrections Act of 1987, provides specific relief to forest product manufacturers that I believe should be extended to the two Potlatch projects as well. Like the projects receiving specific transition relief in the Bill, the two projects undertaken by Potlatch in Minnesota and Idaho were planned in substantial reliance on prior law. Over $2.4 million was spent prior to December 31, 1985 in engineering, design, planning, and other costs for the two plants. If not for circumstances relating generally to the economic decline of the industry and specifically to an unforeseen takeover attempt, both projects would likely have qualified for transition relief under section 211 of the Act.

To avoid providing an unfair competitive advantage to firms currently protected in the Technical Corrections Act, I would hope the Committee would extend this transitional relief to the two projects undertaken by Potlatch Corporation.

Your consideration of the above request is appreciated.

Best regards

Bill

Bill Frenzel
Member of Congress

BF:dw
enclosure

(The statement is at page 410.)

BRENDAN HALL
ATTORNEY AT LAW
1221 E. POLK
P. O. BOX 2725
HARLINGEN, TEXAS 78550

TELEPHONE 512/428-3986

RENE B. GONZALEZ, ASSOCIATE

July 14, 1987

FEDERAL EXPRESS

Robert J. Leonard
Chief Counsel,
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H. R. 2636, The Technical Corrections Act of 1987, Section 102(d)(11)

Dear Mr. Leonard:

I represent the City of Harlingen Waterworks System whose wastewater treatment projects were exempted by Section 204(a) paragraph (10) of the Tax Reform Act of 1986. We have reviewed the proposed technical correction language which appears in Section 102(d)(11) of the Technical Corrections Act. We are in agreement that the proposed correcting language properly clarifies the intent of the Tax Reform Act's provision. We would like to go on record in support of the proposed language in Section 102(d)(11).

We would also like to express our gratitude to the Ways and Means Committee for its untiring work on this important legislation. We appreciate your providing us with this opportunity to review the proposed language and submit our comments in support thereof.

If you have any questions regarding this matter, please don't hesitate to contact me.

Very Truly Yours,

Brendan Hall

BRENDAN HALL

Squire, Sanders & Dempsey

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July 9, 1987

HAND DELIVERED

Robert J. Leonard, Esq.
Chief Tax Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Comments on H.R. 2636, Technical Corrections Act of 1987, Effect of 1986 Tax Reform Act Retroactive Repeal of Investment Tax Credit on Horizon Air

This statement explains an unusual and totally unforeseen problem now facing Horizon Air Industries, Inc. d/b/a Horizon Air, a large commuter air carrier based in Seattle, Washington, as well as its parent corporation, Alaska Air Group, Inc. also headquartered in Seattle. The problem arises from the retroactive repeal of the investment tax credit which under the legislative history of the 1986 Tax Reform Act was not supposed to adversely affect contracts entered into prior to January 1, 1986. However, because of the unusual confluence of circumstances set forth below, Horizon will be deprived of any investment tax credit unless a technical correction addressing Horizon Air's problem is included in H.R. 2636.

The relevant facts are next discussed.

On August 30, 1985, Horizon Air Industries ("Horizon") entered into a contract for the purchase of ten new DHC-8 aircraft from The De Havilland Aircraft of Canada Limited ("De Havilland") at a cost of $5.55 million each (total purchase price of $55.5 million). Horizon made a downpayment of $1 million on the contract. Expected delivery dates were December 1985 through November 1986. Horizon agreed to assign the purchase contracts to UT Financial Services Corporation ("UT Financial") in December 1985 and to lease the planes back from UT Financial. The leases contemplated that UT Financial would be entitled to an investment tax credit of 10 percent of the cost of each plane and provided that, if such credits were not available, Horizon would pay an increased monthly rent to UT Financial over the 14 year lease term.

The Tax Reform Act of 1986 retroactively repealed the investment tax credit for property placed in service after 1985 unless certain transitional rules applied. Horizon satisfies one of the statutory transitional rules since it had a binding contract to purchase the aircraft prior to December 31, 1985. However, the Conference Report states that the "binding contract" exception is not available if a contract has a liquidated damages clause providing for damages of under 5 percent of the contract price. Since the Horizon-De Havilland contract limited damages to the $1 million downpayment (roughly 2 percent of the contract price), it would not be considered "binding" under that report, despite the fact that $1 million is by no means a minimal amount of damages.

The obvious policy behind the Conference Report is to require that payments under a liquidated damages clause in a purchase contract be significant enough such that the buyer will not easily "walk away" from the contract. Only under such circumstances can a contract truly be considered binding. In implementing this policy, the Conference Report assumed that a 5 percent damages clause would ensure that a buyer would not default on a contract. However, in the context of a company such as Horizon, those same policy considerations are satisfied in the instant case. Clearly Horizon was not going to walk away and leave $1 million on the table. Horizon's average operating revenues for its 1984 and 1985 fiscal years were only $51 million and it had an average net operating profit of only $1.15 million for those same years. The $1 million downpayment was extremely significant to Horizon and ensured it would honor this contract, as in fact, it did. Obviously, this contract was binding on Horizon when it was signed in 1985 in every real sense of the word.

Nine of the ten planes were in fact placed in service during 1986 (one each in February, March, June, September and November and four in December) and Horizon is paying additional monthly rents of approximately $58,900 because of the unavailability of the investment credit. Over the fourteen-year lease term, Horizon will be required to pay approximately $9.9 million in additional rents, which costs must be passed on to air travel customers in the Northwest United States. To the extent the costs cannot be passed on to customers, Horizon will have to reduce its employee or other costs to remain competitive, thus setting off significant repercussions among Horizon's almost 1000 employees in the states of Washington, Oregon, Idaho, Montana and Utah.

In April 1987, UT Financial exercised its contractual right to lock-in the higher monthly lease payments predicated on the assumption that the investment tax credit would not be available. However, UT Financial also transferred to Horizon the right to pursue the investment tax credit to which Horizon believes it should be entitled. If Horizon Air can realize the investment tax credit on these 10 aircraft which it most certainly deserves and thereby partially offset the now permanent higher lease payments Horizon is required to pay UT Financial, that savings can be passed on to its customers in the form of fare reductions as well as helping Horizon's employees and the many businesses which rely on Horizon.

Sincerely yours,

Marshall S. Sinick

JOINT MARITIME CONGRESS

Hall of the States Building, 444 North Capitol Street, Suite 801, Washington, DC 20001 Telephone (202) 638-2405

Bruce J. Carlton
Executive Director

July 8, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Building
Washington, D.C. 20515

Dear Mr. Chairman:

Pursuant to your request for comments on provisions in H.R. 2636, the Technical Corrections Act of 1987, the Joint Maritime Congress, a research and educational group representing U.S.-flag steamship companies engaged in both the foreign and domestic trades, submits the following for your consideration.

At issue is the inadvertent omission of the transition rule in the Tax Reform Act of 1986 for one of the four U.S.-flag car carriers seeking retention of the Investment Tax Credit. Let me explain briefly the circumstances which led to this oversight.

During the latter part of 1985, three of our member companies -- Marine Transport Lines of Secaucus, New Jersey; Maritime Overseas Corporation of New York; and Central Gulf Lines of New Orleans -- were successful in consummating contracts with Japanese automobile manufacturers for the employment of four vehicle carriers to operate under the U.S. flag with American officers and crew. These contracts were considered a significant breakthrough in a trade where no U.S.-flag vehicle carriers have ever participated. All three of these U.S.-flag steamship companies were required, as part of the financing, to guarantee the availability of the investment tax credit which existed at the time their respective contracts were finally executed in early 1986.

As you may know, Japanese car manufacturers currently export about 2.3 million automobiles to the U.S. annually and almost all of them arrive here on Japanese-controlled vehicle carriers. Hence, these first four newbuildings represent a significant breakthrough for the U.S. merchant marine. Indeed, the encouraging aspect of this new business is that it is strictly a commercial venture being undertaken with no federal assistance. These initial contracts, negotiated for a period of many months in 1985, represent the kind of aggressive foreign trade ventures that we all know this country needs.

Unfortunately, there was some committee confusion over the number of vessels that needed transition rule relief and this is why this matter still goes unresolved.

The origin of the confusion relating to the company omitted, Marine Transport Lines, stems from a Senate memorandum, attached at Tab A, that explains that only three of the four vessels needed transition rule relief. A similar misunderstanding existed initially by the leadership of the Merchant Marine & Fisheries Committee, but the record was corrected as evidenced by the letters, at Tabs B and C, from Senator Frank Murkowski (R-AK) and Congressman Walter B. Jones (D-NC) and others.

As matters now stand, the transition rule for Central Gulf Lines was included in the Tax Reform Act of 1986, and ITC relief for

Maritime Overseas Corproation has been included in H.R. 2636, the Technical Corrections Act of 1987. Unfortunately, transition rule relief for Marine Transport Lines, ironically the first of the three companies to enter this new market, has still been left out even though all three companies need preservation of the ITC.

It would be grossly unfair for three of the vehicle carriers entering this new trade to be preferred over the other carrier when all of the vessels are identically situated. Moreover, we are convinced that the Congress did not so intend. We believe it would be far more prudent to encourage these companies to proceed with the deals worked out earlier without the rug pulled out from under them.

In view of the foregoing, I would respectfully request that H.R. 2636 be amended to include the following provision:

> *(P) The amendments made by section 201 shall not apply to a new automobile carrier vessel to be registered under the United States-flag, the construction contract and charter for which were negotiated during 1985 and a binding construction contract, not to exceed $22,000,000, was entered into before June 1986 by Marine Car Carriers, Inc., which vessel will be used to transport vehicles in the foreign waterborne commerce of the United States and in other international commerce.*

Sincerely,

Bruce Carlton

Bruce J. Carlton
Executive Director

TO: Senator Packwood DATE: June 18, 1986

FROM: Senator Murkowski

SUBJECT: Transition Rule for Car Carriers

As I mentioned the other day on the Floor, I have strongly urged the Japanese to contract with US shipping lines to build ships to carry Japanese automobiles to the United States. Japan imports over 2 million cars, and up to now has controlled the transportation trade. Through direct contact with Prime Minister Nakasone, coupled with my Sense of the Senate Resolution (S. 223), we have helped move the Japanese to negotiate four car carrier contracts to date. Each car carrier will be crewed by US merchant seamen (about 20 per vessel). We are pursuing two policy objectives by encouraging car carrier contracts: to take a share of the service trade with Japan, and to create jobs in the maritime industry.

NEED FOR A TRANSITION RULE:

The phase out of the Investment Tax Credit is January 1, 1986. Only one of the car carrier contracts was actually executed before that date. Three other contracts were executed in late January, and in May 1986.

However, negotiations leading to the three post-January 1 contracts consumed literally months of effort, and in all cases agreements in principle were struck in late 1985 or early 1986.

The availability of current investment tax credit law played an integral part in enabling the US firms to compete for the carrier contracts. The credits are intended to offset costs that the Japanese were unwilling to bear, including workers' compensation expenses.

To insure that US shipping lines can pursue these agreements, I propose the attached transition rule to permit them to use their investment tax credits. The revenue loss associated with this rule should not be substantial, and, as Bill Diefenderfer indicated, Committee staff will run the revenue impact analysis.

I would greatly appreciate your consideration of this transition rule in the context of the Conference Committee.

FRANK H. MURKOWSKI
[illegible]

United States Senate
WASHINGTON, DC 20510

October 7, 1986

Senator Bob Packwood
SR-259
Washington, D.C. 20510

Re: Transition Rule Under H.R. 3838 for Certain United States-Flag Vehicle Carriers

Dear Bob:

I am writing to you about an oversight that has occurred in the number of certain U.S.-Flag Japanese car carrier vessels that need the relief of a transition rule under H.R. 3838. I have also written to Senator Matsunaga, Senator Bradley, and Senator Lautenberg about this.

I have previously urged Senate conferees to protect, under the Tax Reform Act, the investment tax credit for certain United States-flag vehicle carriers that would be employed in the Japan/United States automobile trade. My interest in this matter stems from my discussions beginning in 1983 with the Japanese urging them to employ some reasonable number of United-States flag carriers in a trade where United States-flag carriers had been completely excluded. In 1985, I introduced a sense of the Senate resolution (S. Res. 223) urging a remedy for this situation. Since then Japanese automobile manufacturers agreed to charter four United States-flag vehicle carriers.

Unfortunately, there has been some confusion over the number of vessels that need the relief of the transition rule. Although my office was fully aware that the Japanese had concluded arrangements to charter four United States-flag vehicle carriers, it was our clear understanding that only three of vessels required protection under the transition rule because of the contract dates involved. It now appears, however, a fourth vessel requires the transition rule.

The fact that all four vessels required the transition rule was made clear to each of the Senate and House conferees on H.R. 3838, but not to our office. On August 7, 1986, the leadership of the House Merchant Marine and Fisheries Committee sent a letter (copy enclosed) to Chairman Rostenkowski and to each of the other House conferees pointing out that there were four vehicle carriers that were similarly situated which should receive the same protection under a transition rule concerning the investment tax credit. Additional correspondence from MEBA was sent to Senate conferees.

It may be that the failure to include all of the vessels in the transition rule was an oversight.

As matters stand now only three of the four vessels are included in the transition rule and in the Concurrent Resolution (H. Con. Res. 395) to correct technical errors in the enrollment of H.R. 3838. The Conference Report to accompany H.R. 3838 (page I-79) includes only two vessels:

> (C) SPECIAL AUTOMOBILE CARRIER VESSELS.-The amendments made by section 201 shall not apply to two new automobile carrier vessels which will cost approximately $47,000,000 and will be constructed by a U.S.-flag carrier to operate, under the U.S.-flag with an American crew, to transport foreign automobiles to the United States, in a case where negotiations for such transportation arrangements commenced in April 1985, formal contract bids were submitted prior to the end of 1985, and definitive transportation contracts were awarded in May 1986.

At my urging, the concurrent resolution adds one additional vessel which was included in my original transition rule request:

> (P) The amendments made by section 201 shall not apply to a new automobile carrier vessel, the contract price for which is no greater than $28,000,000 and which will be constructed by Maritime Overseas Corporation to transport, under the United States flag and with an American crew, foreign automobiles to North America in a case where negotiations for such transportation arrangements commenced in 1985 and definitive transportation contracts were awarded before June 1986.

Clearly, the fourth vessel should receive assistance on the concurrent resolution in the Senate. The contracts that were concluded by the companies that would own and operate these vehicle carriers are very marginal insofar as profitability is concerned. If the ITC were to be denied to one vessel, it would not only be unfair, but that vessel could be rendered uncompetitive in a very competitive market. Making the ITC available to all four of these vessels will also assure that they will remain under the United States flag.

Therefore, I request that you assist in any way you can to correct this oversight and to include the following transition rule for the vehicle carrier that has been omitted:

> The amendments made by section 201 shall not apply to a new automobile carrier vessel, the contract price for which is no greater than $22,000,000 and which will be constructed by Marine Transport Lines, Inc. to transport, under the United States flag and with an American crew, foreign automobiles to North America in a case where negotiations for such transportation arrangements commenced in 1985 and definitive transportation contracts were awarded before June 1986.

Thank you for your consideration.

Sincerely,

Frank H. Murkowski
United States Senator

Enclosures

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U.S. House of Representatives
Committee on
Merchant Marine and Fisheries
Room 1334, Longworth House Office Building
Washington, DC 20515

August 7, 1986

Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
House of Representatives
Washington, D. C. 20515

Dear Dan:

Reference is made to our letter to you of July 22, 1986, (copy enclosed) concerning a transition rule for automobile carriers that will be offered during the conference on H.R. 3838 by Senator Russell B. Long.

As stated in that letter, Senator Long's proposal would retain the investment tax credit for three United States-flag vehicle carriers which will be constructed for United States companies and will be used to transport vehicles from Japan to the United States.

Senator Long's proposed transition rule assumes that there are only three vehicle carriers involved in this situation which should be protected insofar as the investment tax credit is concerned. We are now informed that there are four vehicle carriers that are all similarly situated and should receive the benefit of the transition rule. Therefore, in order to treat all companies that come within the intent of Senator Long's transition rule alike, we request that you support the following proposed transition rule:

PROPOSED AMENDMENT: "AUTOMOBILE CARRIERS"

At page 1518, line 12, add the following as number "(24)" and renumber the ensuing transition rules:

"(24) Special Automobile Carrier Vessels -- The amendments made by Section 201 shall not apply to four (4) vehicle carrier vessels which will be constructed by or for United States companies at a total cost of approximately $94,000,000 under transportation contracts that were negotiated during 1985 and were consummated prior to June 30, 1986; the vessels that are subject of this rule shall be documented under the laws of the United States, comply with United States manning laws, and be used to transport vehicles in the foreign commerce of the United States.

Sincerely,

Bob Davis

ROBERT W. DAVIS
Ranking Minority Member
Committee on Merchant Marine
and Fisheries

Walter B Jones

WALTER B. JONES
Chairman
Committee on Merchant Marine
and Fisheries

GENE SNYDER
Ranking Minority Member
Subcommittee on Merchant Marine

Mario Biaggi

MARIO BIAGGI
Chairman
Subcommittee on Merchant Marine

Same letter to

Pickle
Rangel
Stark
Gephardt
Russo
Pease
Duncan

Archer
Vander Jagt
Crane

Before the
Committee on Ways and Means
United States House of Representatives

Re: Technical Corrections Act of 1987, H.R. 2636

STATEMENT OF MICHAEL C. BERKOWITZ, VICE
PRESIDENT OF MARINE TRANSPORT LINES, INC.

My name is Michael C. Berkowitz. I am Vice President of Marine Transport Lines, Inc. (MTL), whose main corporate offices are located in Secaucus, New Jersey.

MTL operates more than 60 vessels in foreign oceanborne commerce, fifteen of which are United States flag. We were the first American company to contract for a United States-flag vehicle carrier. That vessel, the MARINE RELIANCE, chartered by a wholly owned subsidiary of MTL was delivered to our company on June 22, 1987.

Ironically, although we were the first American company to contract for a United States-flag vehicle carrier, our vessel is the only one of the four such vessels that has been excluded from transition rule relief for preserving the investment tax credit. This exclusion is clearly the result of an oversight.

At the naming ceremony of the MARINE RELIANCE, at the Oppama shipyard of Sumitomo Heavy Industries, Mike Mansfield, the United States ambassador to Japan stated that the vessel was

> "...a fine example of the willingness of Japanese and American businesses to work together... I hope that the cooperation can help lessen some of the trade tensions that exist between the United States and Japan."

We are aware of the Committee's intention to limit matters in the Technical Corrections Act to those items that are legitimately "technical corrections and clarifications." The matter covered by this testimony falls within that category, and we believe it involves a situation that is sui generis under the Tax Reform Act.

The omission of MTL's vehicle carrier in the transition rules either in the Tax Reform Act or in the Technical Corrections Act, which cover three other United States-flag vehicle carriers, involves a clear and unfortunate oversight. This oversight was the result of what appears to be confusion and misunderstanding as to how many identically situated United States-flag vehicle carriers were being built by American companies. It seems clear that the Conferees on the Tax Reform Act and Congress intended to include all of the identically situated vessels in the transition rule relief. There would have been no logical reason to do otherwise. The facts are as follows:

During 1985, three Japanese automobile manufacturers undertook negotiations with various American companies concerning the chartering of United States-flag vehicle carriers for the important Japanese/United States automobile trade. These negotiations were the outcome of intense pressure that had been put on the Japanese by American union interests, Senator Murkowski, and by the House Merchant Marine and Fisheries Committee, which had introduced legislation (H.R. 3655) to require the presence of some United States-flag vehicle carriers in this trade. Even though the United States is the largest market for Japanese automobiles and the United States consumer pays the cost of transportation, the Japanese automobile manufacturers, who control the routing of automobiles, had never previously agreed to employ a United States-flag vehicle carrier in this trade.

There were three American companies involved in the construction and chartering of the four United States-flag vehicle carriers. MTL signed a charter contract with Nissan Motor Car Carrier Co. on February 20, 1985 and a shipbuilding contract with Sumitomo Heavy Industries on December 30, 1985. Subsequently, Central Gulf Corporation entered into similar contracts for two vessels and Maritime Overseas Corporation for one vessel with Japanese shipbuilders and Japanese automobile manufacturers.

In June 1986, as the Tax Reform Act proceeded through the Senate, it became apparent that all of these vehicle carriers would need transitional rule relief under the Tax Reform Act in order to be assured of the investment tax credit. The cut-off date in the then proposed legislation for preserving the ITC had by that time been established for binding contracts entered into before January 1, 1986. Although MTL had entered into a shipbuilding and a transportation contract prior to January 1, 1986, it may be arguable that the shipbuilding contract did not become binding within the meaning of the Tax Reform Act until after January 1, 1986. We do not think that it would be fair to have any question with IRS concerning the availability of the ITC for MTL's vehicle carrier. All of the three companies and all of the four vessels should be considered as identically situated for purposes of ITC treatment under the Act. There would have been no reason to exclude one or two of the vessels from ITC relief or to treat any of the vessels differently from one another under the Act. We are convinced that Congress did not so intend.

The root of the problem relating to MTL can be found in a memorandum from Senator Frank Murkowski to then Senate Finance Committee Chairman Packwood, dated June 18, 1986. In this memorandum, Senator Murkowski stated the following concerning a transition rule for the vehicle carriers:

> "The phase out of the Investment Tax Credit is January 1, 1986. Only one of the car carrier contracts was actually executed before that date. Three other contracts were executed in late January, and in May 1986.
>
> However, negotiations leading to the three post-January 1 contracts consumed literally months of effort, and in all cases agreements in principle were struck in late 1985 or early 1986.
>
> The availability of current investment tax credit law played an integral part in enabling the US firms to compete for the carrier contracts. The credits are intended to offset costs that the Japanese were unwilling to bear, including workers' compensation expenses."

Senator Murkowski's understanding that only three of the vessels needed transition rule relief was unfortunately incorrect. A similar misunderstanding existed initially in the House Merchant Marine and Fisheries Committee. Representatives of MTL and National Marine Engineers Beneficial Association (NMEBA) moved immediately to correct the record and to point out that there were four vessels that needed the ITC relief. The following documents reflect these efforts:

> 1. A letter, dated August 7, 1986, from the leadership of the House Merchant Marine and Fisheries Committee to Chairman Rostenkowski (and to other House conferees) in which it was pointed out that there were four vehicle carriers that needed ITC relief--not three--as the Committee had originally understood.

2. Letters, dated August 21, 1986, from C.E. DeFries, President of NMEBA, to Senator Russell Long and to each Senate conferee pointing out that there were four vessels involved and that it would be unfair to treat any of them differently.

Representatives of NMEBA and MTL were led to believe by Senator Long's office that he would introduce at the Conference a transition rule covering all four vehicle carriers. The House Conferees were prepared to accept what Senator Long would introduce. At the Conference, Senator Long introduced a transitional rule covering only the two Central Gulf vehicle carriers.

Until the Conference Report became available in August 1986, the oversight was not discovered by MTL or NMEBA. The closing days of the legislative session were hectic, and it was difficult to speak to any Conferee or to any of the Committee staff members or to have them focus on this issue. Clearly, however, the inclusion of only two vessels rather then four in the Conference Committee Report (Page I-79) was an oversight.

Several additional attempts to remedy the oversight were made including:

1. Letters, dated October 2 and October 7, 1986, to Chairman Packwood and to Senator Matsunaga from Senator Frank Murkowski pointing out that there was "confusion" over the number of vessels which needed transition rule relief and that there were four vessels instead of three, as he had originally assumed;

2. A letter dated October 7, 1986, from Senator Murkowski to Senator Lautenberg and Senator Bradley;

3. A letter, dated October 11, 1986, from Chairman Walter Jones of the House Merchant Marine and Fisheries Committee to Chairman Dan Rostenkowski pointing out that the Committee's previous letter of August 7, 1986 dealing with the transition rule was apparently misplaced and not made available to the House Conferees;

4. A colloquy set forth on the Senate floor on Friday, October 17, 1986 between Senator Packwood and Senator Lautenberg during which Senator Lautenberg stated and Senator Packwood acknowledged that there had been an unfortunate oversight with respect to MTL; and

5. A letter dated March 9, 1987 from Chairman Jones to Chairman Rostenkowski reviewing again the oversight that had occured and urging him to support an amendment for the MTL vessel in the Technical Corrections Bill.

Differing treatment for any of these four identically situated vehicle carriers was clearly not intended by Congress. There were a number of circumstances that contributed to the oversight. First, there was an original understanding by Senator Murkowski and the House Merchant Marine and Fisheries Committee that the

MTL vessel did not need transitional rule relief. Second, there was an understanding by those involved, including the Merchant Marine and Fisheries Committee, that Senator Long would introduce a transition rule for four vessels. Third, attempts to correct the initial misunderstanding concerning the number of vessels involved were unexplainably frustrated, including the apparent misplacement of the August 7, 1986 letter from the Merchant Marine and Fisheries Committee. It seems obvious that the Conferees and the Congress intended to include all of the vehicle carriers that required transitional rule relief in the rule. The colloquy between Senators Lautenberg and Packwood on the Senator floor on October 17, 1986 eloquently attests to the fact that an oversight occurred. That colloquy is attached as an Appendix.

It is understood that the vehicle carrier to be owned by Maritime Overseas Corporation, or a nominee thereof, is included in the Technical Corrections Act. The amendment needed to include the MTL vehicle carrier is as follows:

> (P) The amendments made by section 201 shall not apply to a new automobile carrier vessel to be registered under the United States-flag, the construction contract and charter for which were negotiated during 1985 and a binding construction contract, not to exceed $22,000,000, was entered into before June 1986 by Marine Car Carriers, Inc., which vessel will be used to transport vehicles in the foreign waterborne commerce of the United States and in other international commerce.

Attachment

there has been objection offered to it and it has been indicated there would be no more rollcall votes. If this were pushed, it would require a vote. As strongly as I do support it, I feel the bill cannot go anyplace as long as the amendment is left on it.

Mr. MOYNIHAN. Mr. President, in the circumstances, it having been announced that there will be no more rollcall votes, I do withdraw the amendment reluctantly.

The PRESIDING OFFICER. The Senator has that right.

The amendment (No. 3498) was withdrawn.

Mr. PACKWOOD. Mr. President, I have a series of different colloquies involving the tax bill which have been cleared on both sides. I ask unanimous consent that the colloquies be entered into the RECORD as if given.

The PRESIDING OFFICER. Without objection, it is so ordered.

GENERAL AVIATION TRANSITION RULE

Mr. ROTH. Mr. President, the Packwood amendment to House Concurrent Resolution 395 would have that provision dealing with new airplanes with 19 or fewer passenger seats contained in sec. 204(a)(11) of the enrolled tax bill (H.R. 3838) apply to all such airplanes "manufactured at the point of final assembly in the United States".

I have a question I would like to pose to the distinguished manager of the resolution. Is it his understanding that the expression "manufactured at the point of final assembly" would apply to airplanes initially constructed overseas to which firms located in my State add 10 percent or more value through the installation or completion of: a portion of the avionics; interior finishing process including seats, tables or carpeting; inside or outside lighting; exterior painting; and windows and their component parts?

Mr. PACKWOOD. Yes, that is my understanding. I want to make it clear that this does not mean that a foreign manufacturer could simply fly a completed airplane to the United States, tighten some screws, and claim that the "point of final assembly" for the aircraft is in the United States. What we have in mind with this rule is that at least 10 percent of the value of the airplane must be added in the United States.

Mr. BUMPERS. May I ask the chairman whether this 10 percent value added must all be added at the "point of final assembly" or whether some of this U.S. value may be added through U.S. suppliers? For example, I understand that certain aircraft manufacturers use U.S.-made engines, but these engines are first flown to manufacturing facilities abroad to be attached to the airplanes. The airplanes then are flown to the United States where more U.S. value is added at the point of final assembly. The result is that substantially more than 10 percent of the value added and domestic content of the airplanes made by these companies is from U.S. workers at the point of final assembly and from U.S. suppliers in many States at many points in the assembly process. My question is whether this meets the requirement that 10 percent of the value added be in the United States.

Mr. PACKWOOD. My answer is yes. It makes no difference whether all the 10 percent U.S. value added is added at the "point of final assembly" or whether some of it is added to the airplane earlier in the manufacturing process, as for example, by the installation of U.S.-made engines during the assembly done abroad.

Mr. BOREN. Mr. President, I am very pleased that a transition rule of significant help to the economic development of eastern Oklahoma was included in this concurrent resolution. It was intended that it be originally included in the text of H.R. 3838. Oklahoma Industries has been planning for a long time to undertake this project using tax exempt bonds in order to qualify for lower cost financing as a part of an urban development action grant. This new chicken processing plant would provide 800 jobs for Le Flore county which is suffering from severe unemployment. The grant process has been held up because of the indecision surrounding this tax exemption. I appreciate the assistance of the chairman in helping to clear up this matter. This action will be good news to eastern Oklahoma and to so many who want a chance to work and support their families in these very difficult times in our State.

There is a second provision in this concurrent resolution of importance to Oklahoma, the expansion of the ITC exemption for aircraft assembled in Oklahoma City. My colleague from Arkansas, Mr. BUMPERS, has explained the general purpose of this modification and I am delighted that the Oklahoma facility where British Aerospace assembles its planes has been included.

Specifically, British Aerospace has a facility in Oklahoma City, operated by AAR, where it prepares airplanes for final delivery including modifying planes for customers, installing air conditioning and baggage parts and painting the aircraft. In addition, the planes assembled there use U.S. engines manufactured by Garret Turbine Engine Co. in Arizona.

This Oklahoma facility is a "point of final assembly" within the meaning of the transition rule and substantially more than 10 percent of the value of the aircraft comes from U.S. suppliers, the Garrett and U.S. labor at the AAR facility. In short, by extending the reach of this transition rule to all 50 States, the chairman of the Finance Committee has extended the rule to include the airplanes assembled at the Oklahoma City facility for British Aerospace.

Mr. LAUTENBERG. Mr. President, I would like to address a question to the distinguished chairman of the Finance Committee dealing with a matter we discussed earlier this week.

It deals with what I consider a real and obvious unfairness in the measure before us. It has to do with certain transition rules for the investment tax credit. What we have are three U.S. shipping firms. They will compete in the exact same market—the Japan-United States auto trade. Each firm has a contract to purchase new car carrying ships.

I discussed with the chairman an amendment I intended to offer that would make sure that each firm would get the same transition relief. The amendment related to the Japan-United States auto trade. The Japanese have exported millions of automobiles to the United States. They use some 80 to 90 ocean going vessels to ship those cars. But, the Japanese never used United States-flag ships. One third of those vessels have been Japanese-flag ships. The rest have been flags of convenience. But, never U.S. flags.

Then, Mr. President, the Congress brought pressure. And the Japanese Government, and the Japanese automakers responded. The automakers agreed to use four U.S.-flag ships. That's a modest concession, when you consider that they use 20 times that many ships. But, it was a welcome concession. It means an important toehold in a major market. It means jobs for U.S. merchant seamen. And, by breathing life into the U.S. merchant marine, it means enhanced U.S. national security.

Those four U.S.-flag ships are being built now. They're being built pursuant to contracts with three U.S. shipping firms. Two of the ships are being built for Central Gulf Corp. of New Orleans. One is being built for Maritime Overseas Corp. of New York. And one is being built for Marine Transport Lines of New Jersey.

The ITC for Central Gulf's ships is protected by H.R. 3838. The ITC for Maritime Overseas' ship would be protected by the resolution before us. But, the ITC for Marine Transport would not be protected.

That's unfair. There are three firms, in the identical situation. They will all compete in the same market. If preserving the ITC makes sense for one, it makes sense for all.

If we impair the ability of one firm to compete, we risk undermining our efforts to open up a market with the Japanese. We risk undermining our own credibility.

The fact is that without the ITC, operation by MTL will be uneconomic. It might be forced to back out of its contract. If that happened, the United States would be embarrassed and we would be handing the Japanese an excuse to turn away from United States shipping firms.

Mr. President, the problem is that the Finance Committee staff says that they were never made aware of the need for transition relief for Marine Transport. I, for one, was not contacted by representatives for the shipping firm until last week. They relied upon contacts they made on the House side. The union, which wants the jobs, made their own efforts in the Senate and the House.

The bottom line is that the chairman considers this a new item. And, as I understand the chairman, there are many other Senators with new items. If he opens the door for one, he would feel compelled to open the door for others. If he amends his unanimous-consent agreement to allow an amendment to add one, he would have to amend it to allow amendments for others. There is no time for that. The concurrent resolution would die, and many necessary, clarifying changes of a technical nature would die with it.

Mr. President, I do not intend to kill the resolution. However, I would like to put my concern on the record and to seek a response from the chairman.

Mr. PACKWOOD. Mr. President, the Senator from New Jersey is right. We simply cannot accommodate his amendment, without opening the door to others. However, as we have discussed this matter privately, I do want to say that he raises a justified complaint. There is no fair reason why one of the four ships should be denied relief granted to the remaining three. It puts the shipping firm at a competitive disadvantage. I certainly would not want to impair our efforts to get more U.S.-flag vessels in the Japan-United States auto trade. For that reason, I want to say to the Senator from New Jersey that I look forward to working with him next year to address his concerns.

Mr. LAUTENBERG. Mr. President, I thank the chairman. I regret that this matter was not brought to our attention earlier, so that it might have been included this year. But, I accept his commitment to address the matter next year, and I look forward to working with him to ensure that all three competitors are treated the same.

Mr. President, for the sake of the record, I ask unanimous consent that certain documents pertaining to this matter be printed in the RECORD.

There being no objection, the material was ordered to be printed in the RECORD, as follows:

NATIONAL MARINE ENGINEERS'
BENEFICIAL ASSOCIATION,
Washington, DC, October 14, 1986.

Hon. FRANK R. LAUTENBERG, *U.S. Senate,*
Senate Hart Office Building,
Washington, DC.

DEAR SENATOR LAUTENBERG: I want you to know that you have MEBA's wholehearted support in your endeavor to correct an oversight in the tax reform bill in regard to transitional rules for car carrier contracts.

The Marine Engineers' Beneficial Association has been at the forefront in efforts to persuade the Japanese automobile manufacturers and the Japanese government to employ a reasonable number of United States-flag vehicle carriers in the important Japan/United States automobile trade. Although the United States is the most important market for Japanese automobiles, it has provided no employment for American seamen. This has taken place despite the fact that we permit more than 2.3 million Japanese automobiles to arrive in the U.S. annually—all on Japanese-controlled car carriers.

Three Japanese automobile manufacturers have agreed to charter four United States-flag vehicle carriers for this trade. This is nothing short of a revolution in Japanese trade practices, but it also signifies that we are able now to offer service every bit as efficient as one of our major foreign competitors. Each of the four charters was negotiated during 1985, and charter contracts and construction contracts were consummated before July 31, 1986. The companies—Central Gulf Lines of New Orleans, Louisiana; Maritime Overseas Corporation of New York, New York and Marine Transport Lines of Secaucus, New Jersey—assumed the availability of the investment tax credit in working out the charter rates and the financing.

Because of an apparent oversight, the transition rules and the concurrent resolution to correct oversights, which passed the House of Representatives, includes only three of these vessels—even though they are all similarly situated and they all need the transition rule relief. The carrier contract for Marine Transport Lines was omitted. The consequences of omitting one vessel could adversely impact the American Merchant Marine and render the omitted vessel uneconomic in a very competitive market.

As matters now stand only three of the four vessels are included in the transition rule and in the Concurrent Resolution (H. Con. Res. 395) to correct technical errors in the enrollment of H.R. 3838. The Conference Report to accompany H.R. 3838 (Page I-79) includes only two vessels. The House concurrent resolution adds one additional vessel.

I strongly support your efforts to correct this oversight by including the fourth vessel in the concurrent resolution to correct technical errors that is now before the Senate. Your amendment is essential for badly needed jobs in our merchant fleet. It is important as well in the interest of fairness to all U.S.-flag carriers about to enter this new market.

With kind personal regards.

Sincerely,

C.E. DEFRIES,
President.

KORRUS & KIRCHNER,
Washington, DC, October 7, 1986.

Hon. FRANK R. LAUTENBERG,
Hart Senate Office Building,
Washington, DC.

DEAR SENATOR LAUTENBERG: As the attorney for Marine Transport Lines, Inc. (MTL), which has its headquarters in Secaucus, New Jersey, I should like to call to your attention a gross inequity that now exists in the transition rules to accompany the Tax Reform Act, and to request your assistance. MTL is a United States shipping company which owns or operates more than 30 ships in various bulk trades in international oceanborne commerce.

The transition rule that affects MTL would preserve the investment tax credit for certain United States-flag vehicle carriers, for which construction contracts and charters were negotiated during 1985 and concluded prior to June 1986. During that period, three Japanese automobile manufacturers agreed to charter four United States-flag carriers for use in the Japan/United States automobile trade. MTL had the honor of being the first United States company selected by a Japanese automobile manufacturer.

The contracts that were concluded for the MTL vessel were the result of more than one year of planning and effort. This agreement by the Japanese automobile manufacturers to charter four United States-flag vessels represented a significant breakthrough. Even though the United States is the largest market for Japanese automobiles and the United States consumer pays the cost of transportation, the Japanese automobile manufacturers, who control the routing and choice of ocean carriers, had never previously agreed to employ a United States-flag vehicle carrier in this.

Because of an apparent oversight at the staff level, the transition rules and the concurrent resolution to correct oversights, which passed the House of Representatives, includes only three of these vessels—even though they are all similarly situated and they all need the transition rule relief. Ironically, even though MTL was the pioneer in this effort, the MTL vessel was the one omitted. The consequences of omitting one vessel could be damaging to the American Merchant Marine and render the omitted vessel uneconomic in a very competitive market. This inequity should not be left for technical correction by the next Congress. Let me undertake to explain why the case is not generic.

During 1985, three American companies (MTL, Central Gulf Corp. and Maritime Overseas Corp.) negotiated independently with individual Japanese automobile manufacturers for the construction and charter of four new vehicle carriers to be registered under the United States flag. Because this was considered a breakthrough for the American Merchant Marine, the companies were willing to negotiate contracts that were only marginally profitable. In order to obtain the vessel financing, each company was required to guarantee the availability of the investment tax credit that existed under the Internal Revenue Act at this time. The availability of the ITC was considered essential to the economic feasibility of the contracts. These credits were intended to offset costs that the Japanese automobile manufacturers were unwilling to bear, including workers' compensation expenses.

In the consideration of a transition rule to preserve the ITC for these vessels, there has been some confusion over the number of vessels that need such a rule. The language for the transition rule covering vehicle carriers was sent to Senator Packwood by Senator Murkowski. It was understood that the rule would be introduced by Senator Long at the conference on the Tax Reform Act. Central Gulf Corporation, which contracted for two vessels, is a constituent of Senator Long. Although Senator Murkowski's office was fully aware that the Japanese had concluded arrangements to charter four United States-flag vehicle carriers, it was Senator Murkowski's understanding that only three of the vessels required protection under the transition rule because contracts for the MTL vessel had been concluded prior to January 1, 1986. Unfortunately, Senator Murkowski's understanding was incorrect. All four of these vehicle carriers require the benefits of the transition rule.

The fact that all four vessels require the transition rule was made clear to each of the Senate and House conferees on H.R. 3838 but not to Senator Murkowski's office. On August 7, 1986, the leadership of the House Merchant Marine and Fisheries Committee sent a letter (copy enclosed) to Chairman Rostenkowski and to each of the other House conferees pointing out that there were four vehicle carriers that were similarly situated which should receive the same protection under a transition rule concerning the investment tax credit. On August 27, 1986, the president of the National Marine Engineers' Beneficial Association wrote a letter (copy enclosed) to each of the Senate conferees pointing out this same circumstance and urging that the transition rule include all four vessels. As far as I am aware, the House and Senate conferees intended to treat all of these vessels alike and that the failure to include all of the vessels in the transition rule was clearly an oversight at the staff level.

As matters now stand only three of the four vessels are included in the transition rule and in the Concurrent Resolution (H. Con. Res. 395) to correct technical errors in the enrollment of H.R. 3838. The Conference Report to accompany H.R. 3838 (page I-79) includes only two vessels:

(c) SPECIAL AUTOMOBILE CARRIER VESSELS.—The amendments made by section 201 shall not apply to two new automobile carrier vessels which will cost approximately $47,000,000 and will be constructed by a U.S.-flag carrier to operate, under the U.S. flag and with an American crew, to transport foreign automobiles to the United States, in a case where negotiations for such transportation arrangements commenced in April 1985, formal contract bids were submitted prior to the end of 1985, and definitive transportation contracts were awarded in May 1986.

The concurrent resolution adds one additional vessel:

(P) The amendments made by section 201 shall not apply to a new automobile carrier vessel, the contract price for which is no greater than $28,000,000 and which will be constructed by Maritime Overseas Corporation to transport, under the United States flag and with an American crew, foreign automobiles to North America in a case where negotiations for such transportation arrangements commenced in 1985 and definitive transportation contracts were awarded before June 1986.

I am aware that a number of technical corrections will have to be made in the Tax Reform Act by the next Congress. However, it is important that this oversight should not be left for such action—it should be corrected by including the fourth vessel in the concurrent resolution to correct technical errors that is now before the Senate. If no action is taken on this vessel at this time, it is possible that a decision may be made not to register the vessel under the United States flag. This would be disastrous for the American Merchant Marine and to our national security.

Therefore, I request that you urge Senator Packwood to correct the above oversight, and to include in the concurrent resolution the following transition rule for the vehicle carrier that has been omitted.

The amendments made by section 201 shall not apply to a new automobile carrier vessel, the contract price for which is no greater than $22,000,000 and which will be constructed by Marine Transport Lines, Inc. to transport, under the United States flag and with an American crew, foreign automobiles to North America in a case where negotiations for such transportation arrangements commenced in 1985 and definitive transportation contracts were awarded before June 1986.

Sincerely,

RICHARD W. KURRUS.

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON MERCHANT MARINE
AND FISHERIES,
Washington, DC, August 7, 1986.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR DAN: Reference is made to our letter to you of July 22, 1986, (copy enclosed) concerning a transition rule for automobile carriers that will be offered during the conference on H.R. 3838 by Senator Russell B. Long.

As stated in that letter, Senator Long's proposal would retain the investment tax credit for three United States-flag vehicle carriers which will be constructed for United States companies and will be used to transport vehicles from Japan to the United States.

Senator Long's proposed transition rule assumes that there are only three vehicle carriers involved in this situation which should be protected insofar as the investment tax credit is concerned. We are now informed that there are four vehicle carriers that are all similarly situated and should receive the benefit of the transition rule. Therefore, in order to treat all companies that come within the intent of Senator Long's transition rule alike, we request that you support the following proposed transition rule:

PROPOSED AMENDMENT: "AUTOMOBILE CARRIERS"

At page 1518, line 12, add the following as number "(24)" and renumber the ensuing transition rules:

"(24) SPECIAL AUTOMOBILE CARRIER VESSELS.—The amendments made by Section 201 shall not apply to four (4) vehicle carrier vessels which will be constructed by or for United States companies at a total cost of approximately $94,000,000 under transportation contracts that were negotiated during 1985 and were consummated prior to June 30, 1986; the vessels that are subject to this rule shall be documented under the laws of the United States, comply with United States manning laws, and be used to transport vehicles in the foreign commerce of the United States.

Sincerely,

WALTER B. JONES,
Chairman, Committee on Merchant Marine and Fisheries.
ROBERT W. DAVIS,
Ranking Minority Member, Committee on Merchant Marine and Fisheries.
MARIO BIAGGI,
Chairman, Committee on Merchant Marine.
GENE SNYDER,
Ranking Minority Member, Subcommittee on Merchant Marine.

NATIONAL MARINE ENGINEERS'
BENEFICIAL ASSOCIATION,
Washington, DC, August 27, 1987.

Re: Transition Rule for Certain United States-Flag Vehicle Carriers Under H.R. 3838.

DEAR CONFEREE: The Marine Engineers' Beneficial Association has been at the forefront of efforts to persuade the Japanese automobile manufacturers and the Japanese government to employ a reasonable number of United States-flag vehicle carriers in the important Japan-United States automobile trade. Although, the United States is the most important market for Japanese automobiles and even though this trade provides employment for a considerable number of Japanese seamen (approximately 4,000 billets), it has provided no employment for American seamen. This has taken place despite the fact that we permit more than 2.3 million Japanese automobiles to arrive in the U.S. annually—all on Japanese-controlled car carriers.

As I believe you know, three Japanese automobile manufacturers have recently agreed to charter four United States-flag vehicle carriers for this trade. This is nothing short of a revolution in Japanese trade practices, but it also signifies that we are able now to offer service every bit as efficient as one of our major foreign competitors. Even though this may be a token gesture by the Japanese, we consider it an extremely important step, and we hope it will be the prelude to the introduction of a considerable number of United States-flag vehicle carriers in this trade.

Each of the four charters was negotiated during 1985, and charter contracts and construction contracts were consummated before June 30, 1986. The companies—Central Gulf Lines of New Orleans; Maritime Overseas Corporation of New York; and Marine Transport Lines of Secaucus, New Jersey—assumed the continued availability of the investment tax credit in working out the charter rates and the financing.

These companies have to honor these contracts the increased costs. In fact, they will lose money because the rates they negotiated are so tight that even with the ITC, they expect just to break even. It would be unfair under these circumstances, I believe, to deny the investment tax credit to these four vessels. Although there is still no provision for protecting the investment tax credit for these vessels in the transition rules in either the Senate or the House versions of H.R. 3838, it is my understanding that Senator Russell Long has agreed, in principle, to sponsor an amendment which would protect the investment tax credit for these vessels.

We have discussed this proposed rule with most of the conferees and they have not expressed any objection to the following transition rule, which I hope you will be able to help shepherd through even at this late date.

PROPOSED AMENDMENT: "AUTOMOBILE CARRIERS"

At page 1518, line 12, add the following as number "(24)" and renumber the ensuing transition rules:

"(24) SPECIAL AUTOMOBILE CARRIER VESSELS.—The amendments made by Section 201 shall not apply to four (4) vehicle carrier vessels which will be constructed by or for United States companies at a total cost of approximately $94,000,000 under transportation contracts that were negotiated during 1985 and were consummated prior to June 30, 1986; the vessels that are the subject of this rule shall be documented under the laws of the United States, comply with United States manning laws, and be used to transport vehicles in the foreign commerce of the United States.

We have here the generation of a brand new market, a first for American shipping and the kind of aggressive pro-U.S. trade that we all know this country desperately needs. It will provide hundreds of American jobs and more U.S.-flag vessels—at no cost to our government. It is everything that we have all been working so hard for for so many years.

With all best wishes, I remain

Sincerely,

C.E. DEFRIES,
President.

Mr. BUMPERS. Mr. President, I supported the Senate amendments to the House concurrent resolution and I am disturbed by the House action in rejecting these amendments. The Senate has a legitimate role in the constitutional process and I think the amendments we adopted here should

CHAIRMAN
JOHN JOSEPH MOAKLEY
MASSACHUSETTS

JOHN J. DOOLING
COUNSEL

H-152 THE CAPITOL
(202) 225-9091

U.S. House of Representatives
Committee on Rules
Subcommittee on Rules of the House
Washington, D.C. 20515

June 26, 1987

JUN 26 1987
COMMITTEE ON

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Rob:

I am enclosing a copy of a letter I delivered to Chairman Rostenkowski today on the floor. I thought that you should be aware of this matter as well, as I know that you will soon be considering the Technical Corrections Act of 1987 (H.R. 2636) in the near future.

Thank you for your kind consideration of this matter. If there is anything else you need, please don't hesitate to contact me.

With best wishes, I am

Sincerely,

John Joseph Moakley

Enc.

ONE HUNDREDTH CONGRESS

JOHN JOSEPH MOAKLEY, MASSACHUSETTS, CHAIRMAN

ANTHONY C. BEILENSON, CALIFORNIA
DAVID E. BONIOR, MICHIGAN
TONY P. HALL, OHIO
CLAUDE PEPPER, FLORIDA
GENE TAYLOR, MISSOURI
TRENT LOTT, MISSISSIPPI

JOHN J. DOOLING, COUNSEL
J. WARREN [illegible], MINORITY COUNSEL

U.S. House of Representatives
Committee on Rules
Subcommittee on Rules of the House
Washington, DC 20515-6270

SUBCOMMITTEE OFFICE
H-152 THE CAPITOL
(202) 225-[illegible]

MINORITY OFFICE
421 CANNON BUILDING
(202) 225-[illegible]

June 26, 1987

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
Washington, D.C. 20515

Dear Mr. Chairman:

I am writing to you regarding the matter we discussed yesterday to continue the investment tax credit for certain United States-flag vehicle carriers. As I explained, this relief was needed in order to enable the four U.S.-flag vehicle carriers in the industry to compete with the over one hundred Japanese controlled vehicle carriers.

A transition rule which provided the necessary relief was enacted in the Tax Reform Act of 1986 however, it only included three of the four vehicle carriers. I believe that the exclusion of the one remaining U.S.-flag ship was an oversight, and I am requesting that you consider providing relief for this additional vessel in the bill which you recently introduced to make technical corrections to the Tax Reform Act of 1986 (H.R. 2636).

The Japanese auto manufacturers agreed in 1985 to charter four U.S.-flag vehicle carriers for the transportation of cars to the U.S. This concession by the Japanese was reached after pressure from Congress and the U.S. maritime unions, and was the first time that U.S.-flag vessels have operated in the trade.

The four U.S. vessels were in identical situations. Binding shipbuilding contracts were entered into by each of the U.S. companies involved after January 1, 1986, but before June 1, 1986. In order to preserve the investment tax credit availability for the U.S. companies involved, transitional relief was required. Unfortunately, one of the vessels was not included in the trasition rule and it is for this vessel that I am now asking for relief.

I would propose that the amendment to H.R. 2636 be as follows:

> (P) The amendments made by section 201 shall not apply to a new automobile carrier vessel to be registered under the United States-flag, the construction contract and charter for which were negotiated during 1985 and a binding construction contract, not to exceed $22,000,000, was entered into before June 1986 by Marine Car Carriers, Inc., which vessel will be used to transport vehicles in the foreign waterborne commerce of the United States and in other international commerce.

This language is what I would suggest will provide the necessary relief for the remaining U.S.-flag vehicle carrier, but I would of course leave it to your expert tax staff to review this language.

It is also my understanding that in a floor colloquy on the Senate floor on October 17, 1986 between Senator Lautenberg and the then Chairman of the Senate Finance Committee, Senator Packwood agreed that there was "no fair reseaon why one of the four ships should be denied relief granted to the remaining three" and he agreed to work on this problem in the upcoming year.

Mr. Chairman, I thank you in advance for your kind consideration in this matter. I am enclosing some additional materials on this matter for your information. If there is anything else I can do for you, please don't hesitate to contact me, or Eric Schwartz on my staff, at x5 9091.

With best wishes, I am

Sincerely,

Joe Moakley

John Joseph Moakley

OVERSIGHT IN THE TECHNICAL CORRECTIONS ACT RELATING TO A U.S.-FLAG VEHICLE CARRIER

In response to pressures from Congress and U.S. maritime unions, Japanese automobile manufacturers agreed in 1985 to charter four United States-flag vehicle carriers for the Japan/U.S. vehicle trade. Although this was a token gesture in a trade where the Japanese control approximately 100 vehicle carriers, it was considered an important breakthrough since no U.S.-flag vessel had ever operated in the trade.

In order to obtain financing the U.S. companies involved had to guarantee the availability of the ITC as it then existed under the Internal Revenue Act. The four vessels are identically situated. Binding shipbuilding contracts were entered into by each of the U.S. companies involved after January 1, 1986 but before June 1, 1986. Each vessel, therefore, required transition rule relief in order to preserve the ITC. Because of an oversight during the closing days of the session, one of the vessels, ironically the first one to be contracted for, was left out of both the Transition Rule and the Technical Corrections Act. This oversight is described in a colloquy on the Senate floor on October 17, 1986 between Senator Lautenberg and, the then Chairman of the Senate Finance Committee, Senator Packwood, which is attached.

The amendment needed to include the omitted vehicle carrier in the Technical Corrections Act is as follows:

> (P) The amendments made by section 201 shall not apply to a new automobile carrier vessel to be registered under the United States-flag, the construction contract and charter for which were negotiated during 1985 and a binding construction contract, not to exceed $22,000,000, was entered into before June 1986 by Marine Car Carriers, Inc., which vessel will be used to transport vehicles in the foreign waterborne commerce of the United States and in other international commerce.

[Attachment is identical to Congressional Record pages preceding this submission.]

July 17, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Leonard:

Re: Section 102(d) of The Technical Corrections Act

In response to your request, we respectfully submit the following comments regarding the Technical Corrections Act of 1987.

I. Relevant Provision of the 1986 Tax Reform Act.

Section 204(a)(2)(A) of the Tax Reform Act of 1986 ("the Act") states that the Act's provisions that modify the Accelerated Cost Recovery System shall not apply to any property which is part of a project

> which is certified by the Federal Energy Regulatory Commission before March 2, 1986, as a qualifying facility for purposes of the Public Utility Regulatory Policies Act of 1978.

The Conference Report includes the following explanation of Section 204(a)(2)(A) at page II-61:

> This rule will not apply if a FERC license or certification is substantially amended after March 1, 1986. On the other hand, minor modifications will not affect the application of this rule (e.g., technical changes in the description of a project, extension of the deadline for placing property in operation, changes in equipment or in the configuration of equipment). (Emphasis added.)

The Conference Report further states at page II-61 that "the committee intends that substance should control over form, and property will remain transitional property if no substantial change occurs." (Emphasis added.)

II. The Project.

Affiliates of PacifiCorp, Bechtel Development Company, and Pyropower Corporation have formed a partnership to build and operate the Mt. Poso Cogeneration Project ("the Project") in Kern County, California near Bakersfield. The Project is a 49.5 megawatt coal-fired cogeneration facility that will be located on the Mt. Poso oil field. Pacific Gas & Electric Company has agreed to buy the Project's first 20 years of electrical output. A portion of the steam produced by the facility would go to oil field tracts contributed to the partnership by National Petroleum Associates, a limited Project partner and an affiliate of the operator of the Mt. Poso oil field. The steam will be injected into the ground to increase oil recovery from these tracts through a process called "thermal enhancement". Use of steam from the project for thermal enhancement would extend the oil field's operation and avoid the need to use some of the recovered oil to produce steam for the same purpose. The net result is that the Project would use a plentiful domestic resource (coal) to enhance recovery of a domestic resource in short supply (oil), while generating electricity as a by-product. The Project would use Pyropower's advanced technology boiler to ensure an environmentally clean operation.

The Federal Energy Regulatory Commission ("FERC") published a notice in the Federal Register of the Project's application for certification as a qualifying facility on April 15, 1985. On June 27, 1985, FERC certified the Project as a qualifying facility for purposes of the Public Utility Regulatory Policies Act of 1978. FERC recertified the Project on November 28, 1986 with the following changes: (A) the steam generator was downsized by about 7.5%; (B) one of the two original general partners was replaced by a new general partner and a new limited partner, although Pyropower Corporation, the principal developer, retains its position as a principal owner and the manager for the Project; and (C) the proposed location of the Project was moved to a different site within the Mt. Poso field. The FERC recertification order stated that all other characteristics of the Project remained unchanged. FERC considered the changes in the Project to be of minor significance which did not warrant publication in the Federal Register of the application for recertification.

III. Congressional Action Concerning the Project During Consideration of the Tax Reform Act.

During consideration of the Conference Report in the House and Senate, several members sought to have language included in colloquies with the tax committee chairmen to confirm that the Project's recertification involved only "minor modifications" that would not affect qualification of the Project as transition property. Although no colloquy addressing the recertified Project appears in the record of final House action on the Act, the record of final Senate action does include a colloquy confirming that replacement of a general partner by other partners, and a change of facility site within the same oil field, were "minor modifications" to a FERC certification order. 132 Cong. Rec. S13,954 (daily ed. September 27, 1986). This colloquy was among several to which Chairman Rostenkowski objected in an extension of remarks published in the Congressional Record. 132 Cong. Rec. E3,391 (daily ed. October 2, 1986).

IV. The Technical Corrections Act of 1987.

As introduced, the technical corrections bill includes no language that would further clarify the transition rule for FERC-certified projects. However, section 102(d) of the bill does extend transition treatment to several cogeneration projects not covered by the Tax Reform Act.

V. Continuing Issue: Change of Project Location as "Minor Modification."

The downsizing of the Project generator is clearly a "minor change in equipment", which explicity qualifies as a "minor modification" under the explanation contained in the Statement of Managers at page II-61. Similarly, the changes in ownership should not disqualify the Project. Unlike, for example, the general transitional rule under section 203(b)(1)(B) of the Act, the special transition rule under section 204(a)(2)(A) imposes no requirement that the taxpayer claiming the benefit of transitional relief have been involved in the construction of the property.

Since the downsizing of the generator and the change in partners are specifically covered by the Act or the Statement of Managers, the only issue raised by the recertification of the

Project is whether the site change was a "minor modification" or a "major amendment." We believe that the site change was a "minor modification" that should not disqualify the Project because section 204(a)(2) only requires that the subject property be "part of a project ... which is certified by [FERC]", and it is the Project, not the site, that was certified by FERC.

The Mt. Poso oil field is 54 square miles in size, and proper Project siting in that field depends on a number of engineering and economic factors, including geological characteristics and user convenience. The Project site was changed to move the Project closer to the oil wells where the steam would actually be used, thereby reducing loss of heat and the associated expense. The end use of the steam remains the same, i.e., thermal enhancement in the recovery of oil from a single geological oil formation, the Mt. Poso field. The Project site is less than 3 miles from the original site.

When asked during floor consideration of the Act to clarify when an amendment to a FERC certification is "substantial", House Ways and Means Committee Chairman Dan Rostenkowski stated:

> [T]he committee felt that a project should not lose its status as transition property if a FERC certificate is amended after September 25 [March 1, 1986 in PL 99-514] as part of routine modification that occurs as a project moves from the drawing board to construction. On the other hand, the committee did not want a project to remain transition property if it became significantly more expensive or it is no longer physically the project originally contemplated. 131 Congressional Record H12812 (daily ed., December 17, 1985).

The recertified Project changes actually resulted in a reduction in the Project's cost. As noted earlier, a smaller steam generator will be used and the Project site relocation will avoid incurring additional expense to prevent heat loss.

The recertified Project is clearly the same project as originally contemplated, particularly in the context of Conference Report language directing that substance control over form.

The physical nature of the Project remains unchanged. The facility will be of the same size and design, will use steam produced by the Project for the same purpose, will operate under the same power sale agreement with the same utility, and will interconnect with the same substation. It will use the same type and source of fuel, and oil recovered at the new site will come from the same oil pool that would have been used if the Project had been built at the original site.

In short, the location of the Project has changed only slightly to accommodate a new user, achieve greater efficiency and reduce costs. This change is a modification of the type that often occurs as a project, such as the Mt. Poso Project, develops from planning to construction.

VI. Benefits of The Project

Transitional treatment of the Project is further supported by the Project's public and private benefits. The Project's first 20 years of operation will produce an estimated $57 million in federal tax revenues, and will ensure the continued productive use of the Mt. Poso field. The Project will also provide an estimated 200 jobs during construction and 30 permanent jobs after operation begins, and will stimulate a number of other jobs with Project suppliers.

VII. Requested Action by the Committee.

We respectfully request that H.R. 2636 be amended to clarify that the Project is transition property and, thus, not subject to the amendment made by Section 201 of the Tax Reform Act. Specifically, we propose that the following amendment be adopted.

> Paragraph (13) of the Technical Correction Act of 1987 is amended by striking out the word "or" at the end of subparagraph (F), by striking out the period at the end of subparagraph (G) and inserting in lieu thereof a comma followed by the word "or", and by inserting thereafter the following new subparagraph:
>
> > "(H) the project, to be located in Kern County, California, was certified by the Federal Energy Regulatory Commission as a qualifying facility for purposes of the Public Utility Regulatory Policies Act of 1978 on June 27, 1985, and recertified by that same authority on November 28, 1986."

VIII. No Effect on Revenue

Because the Project's recertification occurred after passage of the Act, the revenue cost of transitional treatment for the Project has already been accounted for. Thus, confirming transitional treatment of the Project will not cause an unanticipated loss of revenue.

Thank you for your consideration of this request. Please contact any of the following if you have any questions about the request or supporting comments.

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July 16, 1987

BY HAND

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Sections 102(d)(9) and 102(e)(7) of H.R. 2636, the Technical Corrections Act of 1987

Dear Rob:

As you know, the Tax Reform Act of 1986 contains a series of special transition rules to permit certain taxpayers to retain the benefit of ACRS and the ITC under certain circumstances. In the case of one industry, fiber optic telecommunication systems, at least 6 separate systems received transition relief. Section 102(d)(9) of H.R. 2636 would extend this relief to one additional such system.

Mutual Signal Corporation, another such fiber optic telecommunication system is a taxpayer that requires a similar transition rule so that it may be treated in the same fashion as its competitors.

Mutual Signal Corporation ("Mutual Signal"), a wholly-owned subsidiary of Walker Telecommunications Corp. ("Walker") is a company engaged in the business of providing fiber optic communications networks for businesses and individuals. It has placed in service a 420-mile network in Southern Michigan as of February, 1987. This network is within several hundred yards of a competing U.S. Sprint network.

In early 1985 Mutual Signal was formed to operate regional fiber optic telecommunications networks. The Michigan project was undertaken as a pilot project. It connects 13 major cities in Southern Michigan: Ann Arbor, Battle Creek, Bay City, Dearborn, Detroit, Flint, Grand Rapids, Jackson, Kalamazoo, Lansing, Midland, Pontiac and Saginaw. A total of $32.4 million has been invested in the system.

In October of 1985 Mutual Signal obtained interim financing of $31 million for the Michigan project. On February 24, 1986 Mutual Signal entered into a formal agreement with Bechtel Corporation for the construction of its system.

The Tax Reform Act of 1986 includes five separate special transition rules "grandfathering" various fiber optic communications networks for ACRS and ITC purposes. The projects are as follow:

U.S. Sprint	20,000-mile fiber optic network. See § 204(a)(5)(B) of the Act.
MCI	Inter-city communications link passing through at least 10 states. See § 204(a)(5)(C) of the Act.
Teleconnect	Communications network linking cities in Nebraska, Iowa and Illinois. See § 204(a)(5)(P) of the Act.
SouthernNet	Nationwide fiber optic network. See § 204(a)(32)(R) of the Act.
Kansas City Southern Industries (LDX Corp.)	$25 million fiber optic network. See § 204(a)(32)(T) of the Act.

As a result of the above transition rules, there is no "level playing field" for Mutual Signal. It is engaged in head-to-head competition with the companies owning and operating the "grandfathered" systems. Like these systems specifically identified under § 204(a)(5) of the Tax Reform Act, Mutual Signal's system was "placed in service pursuant to a master plan which is clearly identifiable as of March 1, 1986" and was under a formal agreement to commence construction as of February 24, 1986. The investment tax credit that would be permitted to be claimed would be $2.2 million.

Proposed Change

A technical correction to § 211(e)(4) of the Tax Reform Act of 1986 should be made by adding a new paragraph (C).

"(C)" A project that passes through at least 13 cities providing an inter-city communications link through a fiber-optic communications network system and before February 25, 1986, a formal agreement for the construction of the system pursuant to the master plan was entered into and at least $30 million was committed to the construction of the system shall be treated as transition property within the meaning of Section 49(e) of the Internal Revenue Code of 1986.

Should you or your staff have any questions regarding this proposed change, please feel free to call me at any time at 331-7760. Thank you for seriously reviewing this proposed change.

Sincerely yours,

William Morris

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June 18, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing on behalf of the National Hydropower Association to comment on the recently introduced Technical Corrections Act, H.R. 2636.

The Tax Reform Act of 1986 contained a transition rule to the investment credit and depreciation changes for hydroelectric projects. That rule, contained in Section 204(a)(2) of the Act, provides as follows:

> (2) CERTAIN PROJECTS GRANTED FERC LICENSES, ETC. - The amendments made by section 201 shall not apply to any property which is part of a project -
>
> > (C) which is a hydroelectric project of less than 80 megawatts that field an application for a permit exemption, or license with the Federal Energy Regulatory Commission before March 2, 1986.

This rule contains two typographical errors. First, the word "field" appeared instead of "filed," and a comma was omitted following the word "permit."

House concurrent resolution 395, as printed in the Congressional Record of September 25, 1986, contained, in Paragraph 10, a provision to correct these errors:

> (10) On page 69, in the second line, strike out "field" and insert in lieu thereof "filed" and insert a comma after "permit".

Although this is a strictly "technical" correction, it was not included in H.R. 2636 as introduced. I hope that an appropriate correction will be included in any subsequent draft of the legislation.

Sincerely,

Lee M. Goodwin

Affiliated
with the AFL-CIO

National
Marine Engineers'
Beneficial
Association

444 North Capitol Street • Suite 800 • Washington D.C. 20001 • 202-347-8185

July 7, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Building
Washington, D.C. 20515

Dear Mr. Chairman:

In accordance with your request for comments on H.R. 2636, the Technical Corrections Act of 1987, I am writing to draw your attention to an unfortunate oversight as regards ITC transitional relief for one of our contracted-companies, Marine Transport Lines.

By way of background, the Marine Engineers' Beneficial Association has been at the forefront in efforts to persuade Japanese automobile manufacturers and the Japanese government to employ a reasonable number of United States-flag vehicle carriers in the important Japan/United States automobile trade. Although the United States is the most important market for Japanese automobiles and even though this trade provides employment for a significant proportion of the Japanese merchant fleet, it has provided no employment for American licensed officers and crews. This has taken place despite the fact that we permit more than 2.3 million Japanese automobiles to arrive in the U.S. annually -- virtually all on Japanese-controlled car carriers.

After months of intense negotiations dating back to 1985, however, three Japanese automobile manufacturers -- Nissan, Toyota and Honda -- agreed to charter four United States-flag vehicle carriers that would be built for this trade. This is nothing short of a revolution in Japanese trade practices, but it also signifies that we are able now to offer service every bit as efficient as one of our major foreign competitors. Even though this may be a token gesture by the Japanese, we consider it an extremely important step, and we hope it will be the prelude to the introduction of a considerable number of United States-flag vehicle carriers in this trade.

Each of the four charters was negotiated during 1985, and chartering arrangements and ship construction contracts were concluded before July 31, 1986. The companies -- Central Gulf Lines of New Orleans; Maritime Overseas Corporation of New York; and Marine Transport Lines of Secaucus, New Jersey -- assumed the availability of the investment tax credit in working out the charter rates and the financing. Indeed, in order to obtain financing, I am told that these companies were required to guarantee the availability of the investment tax credit that existed under the Internal Revenue laws at the time contracts were negotiated in principle.

With this in mind, our organization worked with your Committee and the Senate Finance Committee toward preserving the ITC in last year's Tax Reform Act for all three companies with plans to construct the four car carrier vessels. Because of an apparent misunderstanding, the Tax Reform Act of 1986 contained a transition rule covering only two car carrier vessels -- those of Central Gulf Lines -- not four as we had been led to believe would occur, despite the fact that all four vessels are identically situated.

Part of this misunderstanding has been corrected as H.R. 2632 currently contains a provision to preserve the ITC for the Maritime Overseas Corporation car carrier vessel. Unfortunately, similar protection for Marine Transport Lines, has somehow been omitted. Ironically, Marine Transport Lines was the first American-flag steamship operator actually to sign a contract yet, they are still left out.

I cannot believe that there is a logical reason for the exclusion of one vessel or that the Congress intended to exclude just one vessel -- the Marine Transport vessel -- from ITC relief. I would, therefore, urge you to consider the following amendment, thereby treating Marine Transport Lines and its vessel in the same way as the other two companies. By doing so, it will provide badly needed jobs for U.S. merchant marine officers and crews as well as more militarily-useful American-flag vessels.

> *(P) The amendments made by section 201 shall not apply to a new automobile carrier vessel to be registered under the United States-flag, the construction contract and charter for which were negotiated during 1985 and a binding construction contract, not to exceed $22,000,000, was entered into before June 1986 by Marine Car Carriers, Inc., which vessel will be used to transport vehicles in the foreign waterborne commerce of the United States and in other international commerce.*

Let me thank you again for your favorable consideration of this matter.

With all best wishes, I remain

Sincerely,

C. E. DeFries

C.E. DeFries
President

National Maritime Union of America

Affiliated with: The American Federation of Labor and Congress of Industrial Organizations
AFL-CIO Maritime Committee
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Shannon J. Wall
President

July 8, 1987

Honorable Dan Rostenkowski,
Chairman
House Ways and Means Committee
1102 Longworth Building
Washington, D. C. 20515

Dear Mr. Chairman:

The National Maritime Union would like to bring to your attention an oversight in the Tax Reform Act of 1986 which we trust can be remedied in H. R. 2636, the Technical Corrections Act.

The unfortunate mistake involves a transition rule granting an Investment Tax Credit (ITC) for certain U. S.-flag car carriers and denying it to others that would be employed in the Japan-U. S. automobile trade. These vessels were contracted for under the assumption that they would all receive the ITC. When the transition rule was originally discussed in the Spring of 1986, it was assumed that three companies -- Marine Transport Lines (MTL), Maritime Overseas Corporation (MOC), and Central Gulf Lines would receive the ITC for their new vessels since they all fell under the general transition rule guidelines.

However, when the Tax Reform Act was finally passed, only the two ships of Central Gulf Lines were granted the ITC. The omission of MOC has been corrected in H. R. 2636, however, the MTL ship is still out in the cold and there is a real danger that we might lose this ship to another flag if a transition rule is not granted.

The original MTL oversight was due in large measure to a misunderstanding on the part of Senator Murkowski who thought that the MTL vessel did not require the ITC transition rule. He later recognized the mistake and wrote to the conferees trying to correct the error. Unfortunately, his message and that of House Merchant Marine and Fisheries Committee Chairman Walter B. Jones were somehow lost and are not reflected in the final bill, nor in H. R. 2636.

We hope that you and the Committee can correct this inequity. The four ships are identically situated and all need the transition rule. To give three vessels relief while denying the fourth the same right is both unfair and illogical. Ironically, MTL was the first of the three companies to enter into an agreement to build a car carrier. Up until then, there was not one U. S.-flag carrier carrying a single car from Japan to the U. S. even though we are the largest consumer of Japanese automobiles. The agreement came after months of intense negotiations and tough congressional pressure.

The Japanese were tough bargainers too; they insisted upon the barest of profit margins. The charter rates for the new ships were so low that the three U. S. companies decided that they could not operate in the trade without an ITC. This is still true today.

The four ships are in various stages of completion. The MTL vessel, *Marine Reliance*, is finished and at this moment is carrying its first shipment of cars from Japan to the United States. It is crewed by the men and women of the National Maritime Union and District One of the Marine Engineers' Beneficial Association. Given the depressed state of the U. S. merchant marine, these new jobs are a lifeline to our members.

Sadly, we doubt that the *Marine Reliance* will be able to remain in the trade and under the U. S.-flag for very long unless it is granted the ITC transition rule like its sister ships. It would be prohibitively uneconomical to operate without the ITC and we think we will have lost yet another ship to a foreign registry.

Congress can prevent this damaging loss by doing the right and fair thing: grant the MTL *Marine Reliance* the ITC transition rule it justly deserves. Therefore, the NMU requests that the following amendment be included in H. R. 2636:

> "The amendments made by Section 201 shall not apply to a new automobile carrier vessel to be registered under the United States-flag, the construction contract and charter for which were negotiated during 1985 and a binding contract, not to exceed $22,000,000, was entered into before June 1986 by Marine Car Carriers, Inc., which vessel will be used to transport vehicles in the foreign waterborne commerce of the United States and in other international waters.

Thank you for your attention and support on this vitally important matter.

Respectfully,

Shannon J Wall

Shannon J. Wall
President

Statement Of
JAMES C. RICE

My name is James C. Rice. I am President and Chief Executive Officer of NorLight. I appreciate this opportunity to express my support, and the support of my company, for the Technical Corrections Act of 1987, H.R. 2636. As I discuss below, this bill is extremely important to NorLight because it contains a non-controversial provision, inadvertently omitted from the 1986 Tax Reform Act, preserving for NorLight's fiber optic telecommunications network the same Investment Tax Credits ("ITC") enjoyed by NorLight's largest competitors. Accordingly, I join the many other parties testifying and submitting written statements who have urged this Committee, and the Senate at large, promptly to enact this measure.

NorLight

NorLight is a partnership of the wholly owned subsidiaries of five Wisconsin and Minnesota electric utilities: Minnesota Power, Madison Gas and Electric, Dairyland Power Corporation, Wisconsin Power and Light, and Wisconsin Public Service Corporation. The partnership was formed in September 1985, after two years of study, to construct a 670 mile, $41,000,000 fiber optic telecommunications network connecting Minneapolis, Milwaukee, Chicago and numerous other points in Minnesota, Wisconsin and Illinois. The goal of the partners was to deliver state-of-the-art fiber optic-based telecommunications services, not just to the upper Midwest's largest cities, but also to the many secondary and tertiary communities in the region which have been bypassed by larger carriers.

NorLight has proceeded rapidly since its formation to achieve this goal. By December 31, 1985, NorLight had signed binding contracts with vendors to purchase $16,657,000 in electronics, materials and engineering services. By July 1986, NorLight had initiated construction, and commenced service to its first customers in February, 1987. The total cost of the network was $41,000,000, $28,000,000 of which would have qualified for an ITC but for the elimination of the ITC under the Tax Reform Act of 1986.

Tax Reform

Although the Tax Reform Act of 1986 represents a welcome overhaul of the Internal Revenue Code, it has also had the unfortunate, if inadvertent, effect of placing NorLight at a substantial disadvantage vis-a-vis its largest competitors. Section 204(a)(3)(B and C) of the 1986 Act specifically preserved the ITC for capital expenditures made or committed after December 31, 1985, for certain fiber optic telecommunications systems which, in addition to meeting other requirements, either pass through at least ten states or involve a network of more than 20,000 miles. A separate ITC transition rule, however, which would have permitted NorLight's 670 mile, three-state network to qualify for the ITC, was inadvertently omitted from the Conference Committee report issued September 18, 1986 and, ultimately, from the Act as passed by Congress. That provision specifically would have retained the tax credit for a project if

> (i) such project involves a fiber optic network of at least 475 miles, passing through Minnesota and Wisconsin; and

(ii) before January 1, 1986, at least $15,000,000 was expended or committed for electronic equipment or fiber optic cable to be used in constructing the network.

When the omission was discovered, this provision was included by the Finance Committee and House Ways and Means Committee (along with other non-controversial technical corrections and transition rules) in the concurrent resolution to the Tax Reform Act, H. Con. Res. 395. The NorLight provision was unopposed throughout House and Senate consideration of the resolution, and received substantial bipartisan support from the Wisconsin and Minnesota Congressional delegations. Nevertheless, because the House and Senate were unable to agree on certain other, unrelated provisions of the resolution, the NorLight transition rule did not become law.

The loss of the ITC for NorLight's capital investment made after December 31, 1985, effectively increased the cost of NorLight's network by one million dollars. Although the dollar amount involved would be significant to any company of NorLight's size, it is even more significant that NorLight's largest competitors -- those with networks that are 20,000 miles long or that pass through ten or more states -- are at this moment benefiting from the ITC of which NorLight has been deprived. In the telecommunications industry, where competition is stiff, this disparate tax treatment has substantially affected NorLight's ability to compete.

The Technical Corrections Act

The Committee has, by including NorLight's ITC transition rule at section 102(d)(9) of the Technical Corrections Act of 1987, taken the first significant step toward eliminating the Tax Reform Act's artificial distinction between NorLight and its competitors. Further, this provision remedies the situation in which NorLight's provision was inadvertently omitted to the 1986 Tax Act from the Conference Report. The NorLight provision continues to receive overwhelming bipartisan support from the Minnesota and Wisconsin Congressional delegations. Until that provision becomes part of the tax code, however, NorLight will continue to experience competitive harm in the marketplace. Accordingly, for the foregoing reasons, I respectfully urge this Committee and the full Senate to act with all due haste to enact this bill into law.

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July 17, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Submission for the Record on H.R. 2636, the
Technical Corrections Act of 1986

Dear Rob:

Potlatch Corporation, a forest products manufacturer with facilities in the South, Midwest and West, would like to submit the attached comment for the record on H.R. 2636, the Technical Corrections Act of 1987. It suggests a correction to the investment tax credit transition rule as it applies to the self-constructed property of forest products manufacturers.

The Tax Reform Act of 1986 (Pub. L. No. 99-514) (the "Act") generally repeals the investment tax credit for qualified property that was placed in service after December 31, 1985. A number of transition rules were provided, however, for taxpayers who had substantially and reasonably relied on prior law in making investment decisions, including special transition relief for five forest products manufacturers.

In providing relief to specific forest product manufacturers, Congress recognized the special economic needs of these firms. However, the economic decline that the industry experienced extends to Potlatch, as well. Had Congress been aware of the Company's two projects in Cloquet, Minnesota and Lewiston, Idaho, it would have included them in the list of properties at forest product mills that received special transition rules. To do otherwise would foster the perception of inequity in the tax laws and give some firms an unfair competitive advantage within the industry.

Therefore, to effectuate the Congressional intent to grant equal treatment to taxpayers similarly situated, transition rules should be enacted that provide relief for Potlatch's projects in Minnesota and Idaho.

Thank you for this opportunity to comment on the technical corrections legislation. We look forward to working with you and your staff on this issue and would be happy to provide the Committee with any additional material that it may need.

Sincerely,

John J. Salmon

Attachment

STATEMENT OF POTLATCH CORPORATION
SAN FRANCISCO, CALIFORNIA

ON H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

The Potlatch Corporation (the "Company") owns and operates forest products manufacturing facilities in the South, Midwest and Western United States. Its main product lines are solid wood products, such as lumber, plywood and oriented strand board, and pulp-based products, such as paperboard, printing papers and consumer tissue. The Company has sought to remain competitive in its operating areas through modernization programs which have involved substantial capital investments over recent years. These capital investment projects have been assisted by the investment tax credit, which was repealed last year. The Company respectfully requests that the Committee extend transition relief from the repeal of the investment tax credit to two projects it undertook prior to January 1, 1986 in reasonable reliance on prior law.

BACKGROUND

The Tax Reform Act of 1986 (Pub. L. No. 99-514) (the "Act") generally repeals the investment tax credit for qualified property that was placed in service after December 31, 1985. The Act provides transition relief in certain circumstances, however. Under section 211(a) of the Act, the investment tax credit remains available for transition property, that is, property to which the depreciation changes made by the Act do not apply. Generally, transition property is property constructed, reconstructed or acquired by the taxpayer pursuant to a written contract that was binding as of December 31, 1985, or for self-constructed property, if the taxpayer had (i) incurred or committed by December 31, 1985 the lesser of $1 million or 5 percent of the cost of the property and (ii) begun construction or reconstruction of the property by that date. In addition, if the class life of the property is at least seven but less than twenty years, then the property must be placed in service no later than January 1, 1989.

Section 204(a)(5) of the Act, however, also treats as transition property certain projects that were part of a master plan. Several forest products mill projects with circumstances similar to the projects under development by Potlatch are enumerated in that subsection. See, section 204(a)(5)(K) of the Act. Projects receiving transition relief include:

- a super calendered paper mill in Duluth, Minnesota;
- a paper mill for the manufacture of newsprint;
- modernization of pulp and paper mills located in Millinocket and/or East Millinocket, Maine;
- installation of a paper machine for production of coated publication papers, modernization of a pulp mill, and installation of machinery and equipment with respect to related processes located in Pine Bluff, Arkansas; and
- property included in a paper plant located in Effingham County, Georgia.

Furthermore, section 102(d)(26) of H.R. 2636, the Technical Corrections Act of 1987 (the "bill"), would exempt the following additional projects that are also similar to the projects under development by Potlatch:

- a wood resource complex; and
- a facility for the manufacture of an improved particleboard in North Carolina.

In substantial reliance on prior law, Potlatch undertook two projects similar to the projects granted transition relief in section 204(a)(5)(K) of the Act, and to the projects proposed for relief in section 102(d)(26) of the bill.

Cloquet, Minnesota Project

The Company decided in 1977 to update the machinery in its mill in Cloquet, Minnesota. The Company spent more than $1.4 million in engineering, design, planning and other costs prior to December 31, 1985 to develop exact specifications of a paper machine and coater and to design the structure in which such equipment would be housed. Nine employees were assigned full-time during 1985 to plan and execute the project. By December 31, 1985, all detailed planning and soil boring had been completed and firm bids had been obtained for the purchase of the major equipment.

The Board of Directors approved the project in principle on December 12, 1985. Only an unforeseen takeover attempt against the Company in November, which led to a substantial immediate reduction in the Company's liquid assets, prevented complete project funding in December 1985. On February 21, 1986, the Board committed the funds to complete the first stage of the expansion, which included the entire housing structure and the paper machine. Property from the first stage will be put in service by the first quarter of 1988. All remaining property in the Company's master plan for Minnesota will be in service by the final quarter of 1988 or the first quarter of 1989.

Lewiston, Idaho Project

Over $1 million was incurred by the Company by December 31, 1985 in engineering, design, planning, equipment and other costs in the replacement of the Company's Lewiston, Idaho sawmill. Although Board approval of complete funding for the project was scheduled for September 1985, economic conditions forced a delay. The mill temporarily shut down. In November 1985 the Company entered into a supplemental labor contract that committed the Company to reopen the plant and to proceed with its rebuilding. Funding approval became infeasible in December 1985 because of the takeover attempt mentioned above. Final funding approval by the Board came on May 2, 1986. Shortly after, construction bid packages were sent out and construction work started in early 1987. The property is scheduled to be placed in service in the final quarter of 1987 or the first quarter of 1988.

The forest products industry experienced serious economic decline in the early to mid-1980's. Hard hit by the drop in demand, investment decisions were delayed. In providing relief to other forest products manufacturers in section 204(a)(5)(K), Congress recognized the special needs of these firms. The Company believes that, had Congress been aware of the Company's two projects, it would have included them in the list of property at other forest products mills that received special transition rules. Like the property at those other mills, Potlatch's property was part of a master plan for development for which significant expenditures had been incurred prior to December 31, 1985.

Moreover, transition rules that cover only certain projects, but not others similarly situated, foster the perception of inequity in the tax laws and actually create a situation where one company has an unfair competitive advantage in the marketplace. In the case of the forest products industry, the failure to develop a generic rule has given the companies whose projects are named in the statute that unfair advantage. The Company asks the Committee only for the same treatment for these two projects that firms similarly situated received in the Act.

POTLATCH CORPORATION
July 17, 1987

Sec. 204. ADDITIONAL TRANSITION RULES
(a) Other Transitional Rules

. . .

(5) SPECIAL RULES FOR PROPERTY INCLUDED IN MASTER PLANS OF INTEGRATED PROJECTS. -- The amendments made by section 201 shall not apply to any property placed in service pursuant to a master plan which is clearly identifiable as of March 1, 1986 for any project described in any of the following subparagraphs of this paragraph:

. . .

(K) A project is described in this subparagraph if either --

. . .

Section 204(a)(5)(K) is amended by adding the following subclause:

(vi) the project involves a paper machine and coater in Cloquet, Minnesota or a sawmill in Lewiston, Idaho, if (1) there had been Board approval of the plans or a supplemental labor agreement requiring completion of the project entered into, (2) more than $1 million in planning, engineering, design or other costs were incurred prior to December 31, 1985, and (3) where binding contracts were delayed due to a takeover attempt of the project owner occurring during the last calendar quarter of 1985.

STATEMENT OF TEXAS AIR CORPORATION

ON

H.R. 2636

THE TECHNICAL CORRECTIONS ACT OF 1987

July 17, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Technical Corrections Act of 1987
Source of Income from Leased
Transitional Aircraft

Dear Mr. Leonard:

We would like to call your attention to a technical problem in the Tax Reform Act of 1986 that was not corrected in the proposed Technical Corrections Act of 1987, H.R. 2636. The problem is caused by the inadvertent termination with respect to transitional aircraft of the prior-law rules for sourcing income from leased aircraft.

I. The Problem

Section 204(c)(3)(A) of the Tax Reform Act of 1986 provided that certain commercial passenger aircraft with respect to which a binding contract was entered into before April 1, 1986 need not be placed in service before 1990 in order to qualify as transitional property under sections 203(b)(1) and 203(b)(3) and thereby continue to qualify for the investment tax credit ("ITC") and for depreciation deductions under the prior-law accelerated cost recovery system ("ACRS"). Due to a technical oversight, an amendment to the foreign tax provisions may have the effect of denying the intended transitional relief to a substantial number of these aircraft.

This problem arises because the Tax Reform Act (1) repealed Internal Revenue Code ("IRC") section 861(e), which treated income from U.S.-manufactured aircraft leased to U.S. persons as income from U.S. sources regardless of where the aircraft was flown, and (2) amended section 863(c)(2)(B), which also treated as from U.S. sources income from aircraft leased to U.S. persons and flown to or from the U.S. Under the new law, all or part of the income from such aircraft is considered as from foreign sources.

In the early years of an aircraft lease, the deductions attributable to the aircraft will exceed the rental income from the lease. The recharacterization of such deductions and income as foreign-source will cause a reduction in the portion of the lessor's income that is treated as from foreign sources. This reduction in foreign-source income will necessarily reduce the lessor's ability to credit taxes paid to foreign countries against U.S. income tax because the fraction used for calculating the amount of foreign taxes available to offset U.S. taxes becomes smaller as foreign income becomes a smaller percentage of the taxpayer's total income.

As a consequence of the changes in the sourcing of income from leased aircraft and the effect of such changes on the foreign tax credit limitation, much of the benefit of transitional relief for commercial passenger aircraft will be unavailable to owners who lease such aircraft to U.S. airlines with international routes. The financial consequences of this loss of tax benefits to the aircraft owner are borne by the U.S. airlines rather than by the lessors. Tax indemnity provisions in aircraft leases pass the cost of increased taxes of the lessor through to the lessee of the aircraft in the form of increased rents.

Although it is appropriate that Congress should determine the source of the income and deductions from aircraft leased to U.S. persons, the rules should not have been changed in the case of transitional craft. The transition rules should consistently and fairly apply to the financing techniques available for the air carrier when it entered into the binding contract to acquire the aircraft. Many carriers contracted to buy airplanes based on their ability to finance the purchase with a lease. In the case of a leasing transaction, the lessor considers not only the ITC and the depreciation but all the tax attributes of the transaction. The resourcing of the income eliminates many lessors that were available under prior law when the contract was signed. Overseas air carriers will be generally restricted to using regulated utilities as lessors, and the cost of leasing aircraft will increase.

We do not believe that Congress, when it changed the sourcing rules, intended to eliminate transitional relief from the repeal of ITC and the changes to ACRS. The sourcing rules, like the availability of ITC and prior-law ACRS, were an important consideration in decisions to enter into binding contracts with aircraft manufacturers. The very same considerations of equity that led Congress to provide transitional relief with respect to ITC and ACRS require that the same relief be extended with respect to the sourcing rules.

II. Solution

Section 861(e) and 863(c)(2)(B) (prior to the 1986 amendment) should continue to apply to aircraft entitled to transitional ACRS and ITC relief.

III. Proposed Correction

Section 1212(f)(2) of the Tax Reform Act of 1986 should be corrected by deleting the period at the end thereof and adding the words "or attributable to property described in Section 203(b)(1) or 203(b)(3) and in Section 204(c)(3)".

We would appreciate your addressing this issue. If you have any questions concerning our description of the problem or our proposed solution, I encourage you to contact either Donald C. Alexander (862-2336) or William T. Brack (659-0702), both of whom are familiar with this matter.

FINLEY, KUMBLE, WAGNER, HEINE,
UNDERBERG, MANLEY, MYERSON & CASEY

Comments of
Toyota Motor Manufacturing, USA
to the
Committee on Ways and Means
U.S. House of Representatives
Regarding
Technical Corrections Act of 1987

July 17, 1987

Toyota Motor Manufacturing, USA, Inc. (TMM) wishes to thank the Committee on Ways and Means for the invitation to comment on H.R. 2636, the Technical Corrections Act of 1987. TMM takes this opportunity to respectfully request that the attached draft legislative language be included in some form in H.R. 2636. This language clarifies that the TMM automobile manufacturing facility would be entitled to transitional relief similar to that already afforded to other automobile manufacturing plants. This statement is submitted on behalf of TMM by its Washington, D.C. legislative counsel who include Price Waterhouse and Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey.

A. Description of the Company

TMM is a U.S. corporation chartered under the laws of the Commonwealth of Kentucky. Its assets consist primarily of an automobile manufacturing plant currently in the final stages of construction which is estimated to cost approximately $800 million. The plant is located 20 miles north of Lexington, Kentucky in Scott County near Georgetown, Kentucky. The Company files federal and state income tax returns and currently employs approximately 1,200 workers in the construction of the plant. When completed later this year, the plant is projected to employ approximately 3,000 Americans on a full-time basis and maintain an annual payroll of approximately $85 million. TMM will create an estimated 35,000 jobs itself and through spinoff industries. The Company expects to produce 200,000 Camry 4-door sedans annually by the early 1990's.

A recent study conducted by the University of Kentucky estimated that the plant will generate approximately $632 million in state income, sales and payroll taxes over the next 20 years from TMM, its suppliers and others drawn to Kentucky by the plant. Substantial additional revenues that, in all likelihood, will exceed that amount will also be generated in federal individual and corporate income taxes.

On July 23, 1985, the Board of Directors of the parent Toyota Motor Company (TMC) initially approved the construction of an automobile manufacturing facility to be located in the U.S. On December 11, 1985, TMC announced that Georgetown, Kentucky would be the site of the production facility. Site preparation began in December 1985. On February 28, 1986, a contract was signed between TMC, its project manager and Kentucky in which the Commonwealth agreed, pursuant to the proposal, to provide plant site and project improvements in exchange for Toyota's promise to locate the plant in Kentucky, with title to the project site, as improved, to be conveyed to TMM upon completion of the project improvements. Excavation of the site began on March 13, 1987.

B. Proposed Revision to the Act

The proposed revision to the Technical Corrections Act would add new subclause (III) to section 204(a)(5)(J)(ii) of the Tax Reform Act of 1986 (the Act). This subclause would include the TMM Kentucky facility as one of the projects described under section 204(a)(5) of the Act. Section 204(a)(5) of the Act provides generally that the changes in the accelerated cost recovery rules (ACRS) made by the Act do not apply to any project described by and under section 204(a)(5). Furthermore, section 211 of the Act provides generally that projects exempt from the new ACRS rules (whether by section 204(a)(5) or some other provision) are entitled to a limited investment tax credit.

If the TMM transition rule ultimately is included in the Act, section 204 and 211 would operate together to permit TMM to use investment tax credit and ACRS depreciation rules similar to those in effect when construction began on the plant. The proposed transition rule would not provide TMM with a full investment credit. Rather, the credit that otherwise would have been allowed under the pre-Act rules is subject to a 35 percent reduction. Furthermore, section 211 would require TMM to reduce its basis in the qualifying property by 100 percent of the credit claimed, instead of the 50 percent reduction provided under prior law.

C. Arguments in Support of Revision

Transition rules are provided in the tax law to assist companies that make significant commercial investments in reliance on the existing tax structure. Last year, Congress recognized this policy by granting transition rules to a number of TMM's competitors operating in the U.S., both domestic and foreign. TMM's pre-Act commitment to the Kentucky plant is indistinguishable from the other integrated projects described under section 204(a)(5)(J). A written plan for the construction of the facility was approved on July 23, 1985 -- well before the House version of the Act crystallized. This fact was recognized in the Senate version of the Act which included a transition rule for TMM. Moreover, it should be noted that TMM is in the final stages of plant construction and is further along in the process than the other projects afforded transitional relief in H.R. 2636.

Toyota has pursued a responsible course in international trade by operating within the U.S., by creating a significant number of U.S. jobs, and by subjecting these operations to U.S. taxing authority. In doing so, it relied on existing U.S. tax laws. U.S. tax policy will undoubtedly be viewed as discriminatory if more favorable tax laws are applied only to domestically-owned auto manufacturers, or joint ventures involving domestically-owned companies, and not to TMM, when TMM is in the same or a more favorable position than other manufacturers. Given the substantial economic commitment that the TMM project represents, it is respectfully requested that the Committee on Ways and Means consider the merits associated with the TMM rule and include some form of the attached provision in H.R. 2636.

FINLEY, RUMBLE, WAGNER, HEINE,
UNDERBERG, MANLEY, MYERSON & CASEY

PROPOSED TECHNICAL CORRECTION TO TAX REFORM ACT OF 1986

RE: TOYOTA MOTOR MANUFACTURING, USA

Section 204 of the Tax Reform Act of 1986, P.L. 99-514, is amended to read as follows: (suggested changes are underlined)

SEC. 204. ADDITIONAL TRANSITIONAL RULES

(a) Other Transitional Rules. --

(5) SPECIAL RULES FOR PROPERTY INCLUDED IN MASTER PLANS OF INTEGRATED PROJECTS. - The amendments made by section 201 shall not apply to any property placed in service pursuant to a master plan which is clearly identifiable as of March 1, 1986, for any project described in any of the following subparagraphs of this paragraph: . . .

(J) A project is described in this subparagraph if -

(i) the project involves an automobile manufacturing facility (including equipment and incidental appurtenances) to be located in the United States, and

(ii) either -- . . . -- or

(III) the Board of Directors of an automobile manufacturer approved a written plan for construction of the project on July 23, 1985, the automobile manufacturing facility (including equipment and appurtenances) will involve a total estimated cost of approximately $790,000,000, and a construction contract was signed on March 14, 1986.

Section 211

STATEMENT OF
ALEX E. MEDOVICH, ESQ.
DIRECTOR OF TAXES, BOWATER, INCORPORATED
on H.R. 2636
the TECHNICAL CORRECTIONS ACT OF 1987
. before the
HOUSE COMMITTEE ON WAYS and MEANS

July 17, 1987

Investment Tax Credit and Basis Reduction for Transition Property Under the 1986 Act

This statement analyzes the provisions of the Tax Reform Act of 1986 ("1986 Act") implementing the reduced investment tax credit ("ITC") and the corresponding adjustment to the basis of property with respect to which the ITC was allowed. Under several possible interpretations of new Section 49 of the Internal Revenue Code of 1986, as amended (the "Code"), it is possible that the basis of property in certain circumstances would have to be reduced by more than the amount of ITC utilized. If this were the conclusion, it could result in a portion of property otherwise subject to the allowance for depreciation which benefits from neither depreciation nor ITC.

We feel that this mismatching of depreciation and ITC was unintended. As discussed below, the legislative history to both the 1986 Act and to prior legislation supports the conclusion that an adjustment to the depreciable basis of assets is appropriate when the correct amount of ITC to be used is finally determined. Attached is an appendix to the statement with proposed technical legislation which would accomplish this result.

This problem can be illustrated by examining the treatment of ITC and the basis adjustment rules as they apply to five different types of property:

- property placed in service in 1985;
- 1985 qualified progress expenditures ("QPEs") attributable to property placed in service in 1986;
- transition property[1] placed in service in 1986;
- Transition Property placed in service in 1987; and
- Transition Property placed in service in 1988.

For purposes of this statement, we have assumed that the property referred to above is placed in service by a calendar year taxpayer who does not have sufficient tax liability to use any ITC for the taxable years 1982 through 1985.[2] With this in mind, each of these types of property will be examined in situations where the tax credit is either used in the year the property to which it relates is placed in service or carried forward and used in any of four applicable years: 1986, 1987, 1988 or 1989.[3]

I. Application of Statutory Law

As discussed below, several uncertainties exist in applying Code Section 49 to the hypothetical situations set forth above. In the paragraphs that follow in this section, we discuss conclusions that can be made by a strict interpretation of the language of Code Section 49. In the first three instances there is little doubt as to the proper conclusions. Following these cases, however, are examples where a literal reading of the Code provides ambiguous conclusions. This ambiguity is more clearly explained in Section II of this statement.

The 1985 current year business credit attributable to ITC for the property placed in service in 1985 and the 1985 QPEs attributable to property placed in service in 1986, under Code Sections 38(a)(2) and (b)(1), is 10% of the cost of the 1985 property and 10% of the amount of QPEs deemed a qualified investment in 1985 under Code Section 46(d)(1)(A). The basis of the 1985 property, for purposes of determining ACRS deductions allowed for the year and gain or loss from the sale or other disposition of the property, is clearly reduced by 5%. Sections 48(q)(1), 168(b)(1), 168(d)(1), 1001(a), 1011(a) and 1016(a)(24) of the Internal Revenue Code of 1954, as amended.

The 1986 current year business credit attributable to ITC for the Transition Property placed in service in 1986, under Code Sections 38(a)(2) and (b)(1), is 10% of the cost, but not including that portion attributable to QPEs taken in 1985, of the 1986 Transition Property. Code Sections 49(b)(1), 46(a)(1) and 46(b)(1). The basis of this property, excluding that portion attributable to QPEs, for purposes of determining the depreciation deduction allowances and gain or loss from the sale or other disposition of the property, is again clearly reduced by 10%. Code Sections 49(d)(1)(A), 48(q)(1), 168(a), 167(a), 167(g), 1011(a) and 1016(a)(22).

The final clear instance is where the ITC attributable to the 1985 property and the QPEs deemed a qualified investment in 1985 are carried forward to 1986 as permitted under Code Section 38(a)(1). In this case, the ITC clearly are allowed in full in 1986, and there is no adjustment to the earlier reduction in basis.

There is less certainty in cases where the ITC for Transition Property must be reduced below the 10% figure. There is also ambiguity as to how to reduce the basis of property attributable to pre-1986 QPEs when such property is placed in service after December 31, 1985.

Code Section 49(d)(1) and (2) could be read to mean that if a taxpayer is permitted a 10% ITC with respect to pre-1986 QPEs, then the portion of the basis of property attributable to these pre-1986 QPEs must be reduced by 10%. An alternative reading of Code Section 49(d)(1) and (2) would require the taxpayer to reduce the portion of the basis of property attributable to pre-1986 QPEs by only 5%.[4]

The 1987 current year business credit attributable to ITC for the Transition Property placed in service in 1987, under Code Sections 38(a)(2) and (b)(1), is 8.25%[5] of the cost of the 1987 Transition Property. Code Sections 46(a)(1), 46(b)(1), 49(c)(3)(A), 49(c)(5)(A) and 49(c)(5)(B)(i). In this case, it appears but is not certain that the basis of this property for purposes of determining the depreciation deduction allowances and gain or loss from the sale or other disposition of the property would be reduced by 10%.[6] Code Sections 49(d)(1)(A), 48(q)(1), 168(a), 167(a), 167(g), 1011(a) and 1016(a)(22).

The ITC attributable to the 1985 property and the 1986 Transition Property, including that portion attributable to QPEs, which is carried forward to 1987, as permitted under Code Section 38(a)(1), must be reduced by 17.5%.[7] Code Sections 49(c)(3)(B), 49(c)(5)(A) and 49(c)(5)(B)(i). There is no provision in the Code for a commensurate and concurrent upward adjustment in 1987 to the basis of this 1985 property and 1986 Transition Property to reflect this 17.5% reduction in allowable ITC.

The 1988 current year business credit attributable to ITC for the Transition Property placed in service in 1988, under Code Sections 38(a)(2) and (b)(1), is 6.5%[8] of the cost of the 1988 Transition Property. Code Sections 46(a)(1), 46(b)(1) and 49(c)(1). Once again, it appears that the basis of this property, for purposes of determining the depreciation deduction allowances and gain or loss from the sale or other disposition of the property, would be reduced by 10%.[9] Code Sections 49(d)(1)(A), 48(q)(1), 168(a), 167(a), 167(g), 1011(a) and 1016(a)(22).

The 17.5% reduction required in 1987 to the amount of (i) allowable ITC carryforward attributable to the 1985 property and the 1986 Transition Property, including that portion attributable to QPEs, and (ii) the 1987 current year business credit attributable to the 1987 Transition Property, must be added back when these amounts become carryforwards to 1988. Code Section 49(c)(4)(B)(ii). These unexpired carryforwards to 1988 must then be reduced by 35%. Code Section 49(c)(2).

In 1988, therefore, the amount of ITC allowable with respect to the 1985 property, the 1986 Transition Property, including that portion attributable to QPEs, and the 1987 Transition Property is 6.5%[10] of the cost of each of these properties. There is no provision in the Code for a commensurate and concurrent upward adjustment in 1988 to the basis of these properties to reflect this 35% reduction in allowable ITC.

In 1989, the amount of ITC allowable with respect to these properties remains reduced by 35%, under Code Sections 49(c)(1) and (2), and is, therefore, 6.5%[11] of the cost of each of these properties. Once again, there is no provision in the Code for an upward adjustment in 1989 to the basis of these properties to reflect this 35% reduction in allowable ITC.

The following chart illustrates the above discussion:

Type of Property	Adjustment to Basis Required by Code Section 48(q)(1) and 49(d)(1)(A)	Percentage of the Cost of the Property that is Allowable as ITC under Code Section 38(a) for the Indicated Taxable Year ("% of ITC Allowed")			
		1986	1987	1988	1989
1985 property	5%	10%	8.25%	6.5%	6.5%
1985 QPEs attributable to 1986 Transition Property	5% or 10%	10%	8.25%	6.5%	6.5%
1986 Transition Property, not including that portion attributable to 1985 QPEs	10%	10%	8.25%	6.5%	6.5%
1987 Transition Property	10%*	N/A	8.25%	6.5%	6.5%
1988 Transition Property	10%*	N/A	N/A	6.5%	6.5%

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* This would appear to be the amount based on a literal reading of Code Sections 49(d)(1)(A) and 48(q)(1).

II. Application of Legislative History of 1986 Act

While little guidance is available under the amended Code itself, the legislative history to these provisions does provide some additional information concerning the the reduced investment tax credit and the basis reduction rules.

Section 211 of the Conference Committee Report No. 99-841, September 18, 1986, on the Tax Reform Act of 1986 (the "Report") explains Code Section 49 differently than a literal reading of that section. The Report states:

> A taxpayer is required to reduce the basis of property that qualifies for transition relief ("transition property") by the full amount of investment credits earned with respect to the transition property (after application of the phased in 35-percent reduction, described below).

(Emphasis added).

Shortly thereafter, the Report also provides:

> 'As described above, a full basis adjustment is required with respect to the reduced amount of the investment tax credit. Thus, for transition property that is eligible for a 6.5 percent investment tax credit, the basis reduction would be with respect to the 6.5 percent credit, not the unreduced 10 percent credit.

(Emphasis added).

Although this language does provide some guidance, it raises several more questions than it answers. In applying this language and the language of Code Section 49 to the situation of property being placed in service in different years as set forth earlier in this statement, it appears that several conclusions are possible.

For example, the adjustment to basis provision may not have been intended to apply to non-Transition Property since the first quote above states that it is applicable to Transition Property only. This coincides with Code Section 49(d)(1) which states that it applies "with respect to transition property."

Even though the statutory language is not clear, the Report is clear that the 35-percent reduction is applied in full for all years to the basis of property placed in service in 1988 and beyond. The Report also makes clear that the basis of property placed in service in 1986 is reduced by a full 10% in 1986.

Several interpretations exist when one applies the Report language to the ITC attributable to property placed in service in 1986 which is carried forward, as permitted under Code Sections 39(a)(1) and 38(a)(1), to 1987, 1988 and 1989. This is also true for ITC attributable to property placed in service in 1987 that is carried forward to 1988 and 1989, and with respect to the current year business credit allowed under Code Section 38(a)(2) for property placed in service in 1987.

We will first discuss the interpretations with respect to property placed in service in 1986 but with respect to which the ITC is carried forward. There is no definition in the Report of the word "earned", as used in the first cite set forth above. Additionally, there is no explanation of what "earned, after application of the phased in 35-percent reduction" means, or whether these terms are to be read together. With respect to the second cite set forth above, one is uncertain of the meaning of the word "eligible," as used therein, since such term has not been defined in the Report.

One could understandably interpret the Report, with respect to property placed in service in 1986 but with respect to which the ITC is carried forward, to mean that when a credit is carried forward to 1987, Taxpayer has either (i) earned, (ii) earned, after application of the phased in 35-percent reduction, or (iii) is eligible for, either a (x) 10% or (y) 8.25% ITC. When the credit is carried forward to either 1988 or 1989, the possible interpretations are either a (x) 10%, (y) 8.25%, or (z) 6.5% ITC. This is illustrated below.

1986 Transition Property not including that portion attributable to QPEs	1986	1987	1988	1989
Possibilities with respect to % of Adjustment to Basis	10%	10% or	10% or 8.25% or	10% or
8.25% or				
		8.25%	6.5%	6.5%
% of ITC Allowed	10%	8.25%	6.5%	6.5%

Similar alternatives would apply with respect to property placed in service in 1987.

III. Clarification of Statutory Law and Amendments to Conform to Historical Law

We believe that Code Section 49 should be revised so as to reflect the intent of the drafters as set forth in the Report language. Such revision would require taxpayers to reduce the basis of Transition Property in the year it is placed in service by the same percentage of ITC which would have been allowed in that year if the ITC had been utilized. In addition, we believe that the basis of the Transition Property should be increased by the amount of any subsequent reduction of allowable ITC; such increase would be effective as of the year in which such reduction became final, such as when the ITC is ultimately used in a carryforward year. This conforms with the historical interplay between the amount of ITC allowed and the basis reduction required. Finally, in order to treat different taxpayers fairly, an upward adjustment in basis should also be permitted for non-Transition Property as the ITC which is attributable to it is reduced under Code Section 49.

IV. Historical Treatment of ITC and Basis Adjustment

These basis adjustment proposals can be supported by prior legislation which dealt with similar problems concerning the interplay between ITC utilization and basis adjustment.

A. The 1962 Act

The Revenue Act of 1962, Pub. L. 87-834, 76 Stat. 960 (the "1962 Act") first enacted an ITC in the amount of 7% of the qualified investment. Section 46(a) of the Internal Revenue Code as in effect in 1962 (the "1962 Code"). Section 48(g)(1) of the 1962 Code required taxpayers to reduce the basis of property with respect to which ITC was allowed by 7%. Such basis, however, had to be increased under Section 48(g)(2) of the 1962 Code whenever a portion of the ITC initially allowed was subsequently disallowed because the property ceased to be a qualified investment or was disposed of before a predetermined period. The basis adjustment had to be made immediately before the event necessitating the adjustment occurred, and had to be made only to the extent ITC was disallowed.

B. The 1964 Act

Section 203(a)(1) of the Revenue Act of 1964, Pub. L. 88-272, 78 Stat. 19 (the "1964 Act") repealed the 7% basis reduction referred to above. Section 203(a)(2)(A) of the 1964 Act required taxpayers to increase the basis of property placed in service before January 1, 1964, "under regulations prescribed by the Secretary of the Treasury or his delegate, by an amount equal to 7 percent of the qualified investment with respect to such property," and if there had been, "any increase with respect to such property under section 48(g)(2) of such Code, the increase under the preceding sentence shall be appropriately reduced therefor."

Income Tax Regulation Section 1.48-7(d)(1) explains that the increase in basis is tied directly to the amount of ITC previously allowed; that is, the increase shall not be "in excess of the net reduction in basis under section 48(g)." This Regulation Section then goes on to explain that the basis adjustment is taken into account for purposes of future depreciation allowances, such that "the total depreciation allowances made during the remaining useful life of the property, plus the allowances for the expired useful life, will equal or approximate the allowances which would have resulted if section 48(g)(1) had not applied."

C. The 1982 Act

The original concept of a reduction in the depreciable basis of property to take account of the ITC returned to the Code in 1982. Section 205(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 323 ("TEFRA") added a new Section 48(q) to the Code requiring taxpayers to reduce once again the basis of property with respect to which ITC is allowed by 50% of the ITC allowed. Code Section 48(q)(2) also allowed taxpayers an upward adjustment in basis immediately prior to the early disposition of property equal to 50% of the amount that must be recaptured by the taxpayer because such early disposition results in a portion of ITC being disallowed. This increase in basis maintains the initial numerical relationship between the ITC allowed and the basis reduction, such that the basis is never reduced by more than 50% of the ITC used. Similarly, if a credit for which a basis adjustment was required expires at the end of the carryover period, a deduction is allowed for one-half of the unused credit.[12]

Code Section 49(q)(4), which was added by TEFRA, further illustrated Congress' intent that the amount of the basis reduction should be directly tied to the amount of ITC allowed and eventually used. Under this section, a taxpayer has the option to reduce the amount of ITC allowed in lieu of reducing the basis of property.[13]

If QPEs were incurred prior to 1983 on property that was not placed in service until after 1983, the basis of the property attributable to the QPEs was not required to be reduced even though the remaining portion of the property was subject to the new basis reduction law. See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at page 37.

FOOTNOTES

1/ Transition property within the meaning of Code Section 49(e), hereinafter referred to as "Transition Property".

2/ Code Section 39(a)(1) permits unused ITC to be carried back to the 3 preceding taxable years and carried forward to the 15 following taxable years.

3/ Due to the limited nature of this statement, some variations in addition to the hypothetical situations set forth herein will not be discussed. Some of these variations, however, may also result in problems in applying Code Section 49, such as when only a portion of a certain year's ITC is carried forward to a taxable year in which a reduction must be made under Code Section 49(c).

4/ If a taxpayer makes an election under Code Section 48(q)(4) with respect to pre-1986 QPEs, the basis of property attributable to these pre-1986 QPEs would not have to be reduced. See Code Section 49(d)(2)(A).

5/ As discussed earlier in this statement, the taxpayer is assumed to be on a calendar year basis. The applicable percentage under Code Section 49(c)(5)(A) is 6 months in the taxpayer's 1987 taxable year after June 30, 1987 divided by 12 months in the taxpayer's 1987 taxable year. This quotient (50%) is multiplied by 35%, and that product (17.5%) is the percentage by which the regular percentage (10%) in Code Section 46(a)(1) is reduced. 10% x 17.5% = 1.75%; 10% - 1.75% = 8.25%.

6/ The literal reading of the Code is as follows. Code Section 49(d)(1)(A) requires one to apply Code Section 48(q)(1) by substituting 100% for 50%. Code Section 48(q)(1), after such substitution, requires one to reduce the basis of property, if a credit is determined with respect to such property under Code Section 46(a), by the amount of the credit determined under Code Section 46(a). The amount of the credit determined under Code Section 46(a) is the regular percentage under Code Section 46(b), or 10%. It is this 10%, or the amount of credit determined under Code Section 46(a), which is then reduced by the applicable percentage under Code Section 49, but the amount of credit determined under Code Section 46(a) remains at 10% for purposes of applying the reduction in basis under Code Section 48(q)(1).

7/ See Footnote 4 supra.

8/ The regular percentage (10%) under Code Section 46(a)(1) is reduced by 35% under Code Section 49(c)(1). 10% x 35% = 3.5%; 10% - 3.5% = 6.5%.

9/ See Footnote 5 supra.

10/ The regular percentage (10%) under Code Section 46(a)(1) is reduced by 35% under Code Section 49(c)(2). 10% x 35% = 3.5%; 10% - 3.5% = 6.5%.

11/ See Footnote 9 supra.

12/ See page 36 of Joint Committee General Explanation of TEFRA.

13/ Code Section 48(q)(4) permits a taxpayer to take only an 8% ITC (4% in the case of 3-year recovery property) instead of the regular 10%, and not reduce his basis by any amount.

14/ This technical amendment was initially proposed by Collette C. Goodman of Hodgson, Russ, Andrews, Woods & Goodyear, Washington, D.C., in the January 16, 1987 issue of Tax Notes Today. It resolves another problem existing in this area which is whether the basis of energy property should be adjusted by Code Section 49(d)(1)(A).

V. Conclusion

The legislative history shows that in the past whenever a taxpayer was required to reduce the amount of ITC allowed to him, he was permitted a commensurate upward adjustment in the basis of the property. This will not be true with respect to ITC carryforwards after July 1, 1987, unless Code Section 49(c) is amended in a manner similar to the proposed technical amendment set forth in the appendix.

Additionally, the percentage of basis reduction of ITC property has never been in excess of the percentage of ITC allowed. This will become the case, however, for the first time in the history of the ITC if the proposed technical amendment, or a similar amendment, relating to carryforwards is not made to Code Section 49(c).

It is also unfair at this point to require taxpayers to reduce the portion of basis attributable to QPEs incurred prior to the change in law by a full 100% of the amount of credit taken rather then the prior 50% amount. When taxpayers incurred QPEs prior to the change in law, they had a choice at that time either to make an election under Code Section 48(q)(4) to reduce the amount of credit but maintain the full basis for depreciation purposes, or to take the full credit and reduce their basis by 50% of the amount of the credit. A taxpayer's decision between these two choices was undoubtedly made by comparing the economic effect of each choice.

For those taxpayers who chose the latter alternative because it was economically more beneficial to them, it is now unfair to require them to reduce this portion of basis by 100%, since they were not aware of this at the time they had to make the aforementioned economic decision. If certain taxpayers had known of this change in law when they made their decision, they would have no doubt opted for a Code Section 48(q)(4) election which would economically be more beneficial in most cases after implementing this change in the law.

APPENDIX

PROPOSED TECHNICAL AMENDMENTS

As discussed in this statement, we feel that the basis reduction should never be greater than the amount of ITC eventually used. This is supported by both the Report language and prior legislation.

1. This method of basis adjustment can be achieved with respect to Transition Property in the year it is placed in service by the following proposed technical amendment to Code Section 49.

Paragraph (1) of Section 49(d) of the Code is amended to read as follows (new matter underlined):

(1) In General. -In the case of periods after December 31, 1985, with respect to the regular percentage of the qualified investment as determined after giving effect to the reductions specified in subsection (c), section 48(q) (relating to basis adjustment to section 38 property) shall be applied with respect to transition property-

(A) by substituting "100 percent" for "50 percent" in paragraph (1), and

(B) without regard to paragraph (4) thereof (relating to election of reduced credit in lieu of basis adjustment).[13]

2. The above proposed amendment resolves the basis adjustment problem with respect to Transition Property for the year it is placed in service. It does not, however, address this problem with respect to ITC carryforwards attributable to both Transition and non-Transition Property which must be reduced under Code Section 49(c)(2). The following language is proposed as a technical amendment to Code Section 49(c), both because it accords with the manner that has historically been used to restore the basis of property when a portion of the ITC attributable to it is disallowed, and because it treats taxpayers on a fair and consistent basis.

Section 49(c)(1)-(4) of the Code is amended to read as follows (new matters underlined):

(c) 35-PERCENT REDUCTION IN CREDIT FOR TAXABLE YEARS AFTER 1986.-

(1) Reduction in Current Year Investment Credit.- Any portion of the current year business credit under section 38(b) for any taxable year beginning after June 30, 1987, which is attributable to the regular investment credit shall be reduced by 35 percent.

(2) Unexpired Carryforwards to 1st Taxable Year Beginning After June 30, 1987.- Any portion of the business credit carryforward under section 38(a)(1) attributable to the regular investment credit which has not expired as of the close of the taxable year preceding the 1st taxable year of the taxpayer beginning after June 30, 1987, shall be reduced by 35 percent, and the basis of the property to which the business credit carryforward is attributable shall be increased under regulations prescribed by the Secretary by an amount equal to the product of -

(i) 35 percent, and

(ii) the basis adjustment required by section 48(q) in the year the property is placed in service, and

(iii) the percentage of the regular percentage determined under section 46(a)(1) which is treated under this subsection as a carryforward.

(3) Special Rule for Taxable Years Beginning Before and Ending After July 1, 1987.- In the case of any taxable year beginning before and ending after July 1, 1987-

(A) any portion of the current year business credit under section 38(b) for such taxable year, or

(B) any portion of the business credit carryforward under section 38(a)(1) to such year, which is attributable to the regular investment credit shall be reduced by the applicable percentage, and the basis of the property to which the business credit carryforward is attributable shall be increased under regulations prescribed by the Secretary in the manner described in subsection (c)(2) of this section, except that subsection (c)(2)(i) shall be replaced with the applicable percentage.

Such basis adjustment shall not be made, under regulations prescribed by the Secretary, with respect to that portion of the credit allowed under section 38(a) which is carried forward to the 1st taxable year beginning after June 30, 1987.

(4) Treatment of Disallowed Credit.-

(A) In General.- The amount of the reduction of the regular investment credit under paragraphs (1) and (2) shall not be allowed as a credit for any taxable year.

(B) No Carryback for Year Straddling July 1, 1987; Gross Up of Carryforwards.- The amount of the reduction of the regular investment credit under paragraph (3)-

(i) may not be carried back to any taxable year, but

(ii) shall be added to the carryforwards from the taxable year before applying paragraph (2), and the basis adjustment required by section 48(q)(1) to property placed in service in the taxable year beginning before and ending after July 1, 1987, shall be added back, under regulations prescribed by the Secretary, with respect to that portion of the property for which the regular investment credit is carried forward to the 1st taxable year beginning after June 30, 1987.

This proposed amendment would apply in accordance with the following example. In the case of Transition Property which was placed in service in 1986, but whose ITC was carried forward until after 1987, the following basis adjustments would apply. In 1986, the basis would be reduced by 10%. For a calendar year taxpayer, on January 1, 1987 the basis would be increased by 1.75% of the original cost. Thereafter, on January 1, 1988, a final 1.75% of the original cost would be added to basis. As a result, the total basis reduction would have been limited to 6.5%, the amount of investment tax credit which the property is ultimately allowed.

3. The following amendment to Code Section 49 would clarify how to reduce the portion of basis attributable to QPEs incurred prior to January 1, 1986.

Paragraph 2 of Section 49(d) of the Code is amended to read as follows (new matter underlined and deletions indicated by).

(2) Special Rule for Qualified Progress Expenditures - With respect to any qualified progress expenditures for periods before January 1, 1986

(A) if the taxpayer made an election under section 48(q)(4), such election shall be valid only for the portion of the adjusted basis attributable to qualified progress expenditures incurred before January 1, 1986, and the election shall not apply to any qualified progress expenditures for periods after December 31, 1985, and

(B) if the taxpayer does not make an election under section 48(q)(4), paragraph (1)(A) shall not apply to that portion of the adjusted basis attributable to qualified progress expenditures incurred before January 1, 1986.

STATEMENT OF
THE EDISON ELECTRIC INSTITUTE

COMMENTS ON H.R. 2636,
THE TECHNICAL CORRECTIONS ACT OF 1987

July 17, 1987

The Edison Electric Institute (EEI) is pleased to comment on H.R. 2636, the Technical Corrections Act of 1987. EEI is the association of the investor-owned electric utilities whose members generate and distribute approximately 75 percent of the nation's electricity.

Under section 211 of the Tax Reform Act of 1986, in the case of periods after December 31, 1985, a taxpayer is required to reduce the basis of property that qualifies for transition relief from the repeal of the regular investment tax credit (ITC) by the full amount of ITC earned with respect to transition property (after application of the phased in 35-percent reduction). See General Explanation of the Tax Reform Act of 1986 (Blue Book), JCS-10-87, pg. 122, May 4, 1987. There exists a problem with respect to ITC which has been given little attention. The problem relates to the 100 percent basis adjustment for ITC and the interrelationship of the 35-percent reduction for credits utilized in 1988 (17.5 percent, 1987) and later years.

For example, assume X Co. acquires property, subject to a transition rule, costing $100 which is placed in service in 1986. The ITC would be $10 and the basis of the property for depreciation purposes would be $90. The credit is utilized by X Co. as part of a carryforward in 1988, but only $6.50 is utilized because of the 35-percent reduction. It is understood that personnel on the staff of the Joint Committee on Taxation are of the view that the $3.50 is not restored to basis in 1988 (or in 1986, by way of an amended return).

This is obviously unfair and should be corrected by a technical amendment. The reduction in basis should reflect the amount of ITC actually utilized, after the application of the phased in 35-percent reduction.

We appreciate the opportunity to provide our comments on this important work of the Committee.

Respectfully Submitted,

Ronald D. Clements
Director, Legislative Affairs

VINSON & ELKINS

MEMORANDUM

July 17, 1987

Coordination of Rules Allowing ITC Pass-Through to Lessees with ITC Basis Adjustment (Section 48(d)(5) of the Internal Revenue Code of 1986 and Section 102(e) of the Technical Corrections Bill of 1986)

Section 102(e) of the Technical Corrections Bill amends section 48(d)(5) of the Internal Revenue Code of 1986 to require lessees to whom investment tax credit ("ITC") is passed through under the provisions of section 48(d) to include 100% of the amount of the ITC in income ratably over the shortest recovery period of the subject property. Under the Tax Reform Act of 1986, as enacted, lessees were required to so include only 50% of the ITC amount.

Although the corrective nature of this proposed amendment from the federal government's point of view is understandable, the fact and timing of the correction creates serious problems for publicly-held corporations which, under financial accounting rules, are required to report earnings to shareholders on the basis of the law as it exists without regard to pending legislation. Therefore, if this amendment is enacted, a company that has placed transition property in service in periods for which financial reports have already been prepared and dessiminated will show an aberational negative impact on earnings which is not readily explicable to shareholders and other persons who rely on financial statements in dealings with the company. This can clearly have a detrimental effect on a company's ability to raise capital.

Therefore, we request the opportunity to discuss and explore possible solutions to the problem created by this proposed amendment.

Supplemental Information

This statement is submitted by John E. Chapoton and Charles L. Almond of VINSON & ELKINS, 1455 Pennsylvania Avenue, N.W., Washington, D.C., 20004-1007, telephone number (202) 639-6500, on behalf of FEDERAL EXPRESS CORPORATION.

STATEMENT
ON
H. R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987
BY
CLAUDE A. BURLESON, VICE PRESIDENT - TAXES
GTE CORPORATION
SUBMITTED TO
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES
JULY 17, 1987

The Tax Reform Act of 1986, H. R. 3838, clearly provides for a reduction in the value of investment tax credits ("ITCs") used to offset U. S. income tax liability in 1987 and succeeding years in order to reflect the fact that tax rates are being reduced. The value of the 10% ITC generated under transition relief or by a carryover from the previous year for a calendar year taxpayer is reduced 17.5% in 1987 and 35% in 1988 and succeeding years to respectively 8.25% and 6.5%. At the same time, the Tax Reform Act of 1986 reduced the value of ITC for "transition property" by requiring a full ITC basis adjustment, as opposed to the one-half basis adjustment of existing law. This full basis adjustment meant that the basis of property qualifying for transition relief would be reduced by 10% in 1986, 8.25% in 1987 and 6.5% in 1988, consistent with the amount of ITC earned.

Congressional intent is certainly clear that the basis of property to be depreciated should be reduced by the amount of ITC being used to offset U. S. income taxes. It is not, however, clear that in the case of an ITC carryover from 1986 to 1987 or from 1987 to 1988 that the basis of property is reduced by the same amount as the ITC being actually used by the taxpayer on a tax return. In those two instances it is possible that the depreciable basis of property may be reduced by more than the amount of ITC utilized (for example, the basis could be reduced by 10% and the taxpayer only uses an 8.25% ITC due to a carryover from 1986 to 1987). Clearly, this would be an inequitable result which is not consistent with the treatment of other ITCs being generated in the same year and the intent of Congress as enunciated in the Conference Committee Report. I have attached, as Exhibit A, a simple example which illustrates the possible "mismatching" that could occur between the depreciable basis and ITC utilized if this situation is not clarified and placed in its proper order by the Technical Corrections Act of 1987.

The most appropriate way to correct any possible misunderstanding with regard to this matter would be to revise Section 49 of the Internal Revenue Code of 1986 to allow for an "upward adjustment" in the basis of depreciable property for any reduction of allowable ITC that occurs in a carryover situation. This type of treatment is consistent with legislative history in similar situations and achieves fairness in the treatment of similarly situated taxpayers that is one of the principal objectives of the Tax Reform Act of 1986. I have attached hereto, as Exhibit B, suggested language that could be used to correct this potentially inequitable situation.

I respectfully submit this technical correction to this distinguished Committee on Ways and Means which I strongly believe is logical, fair and consistent with past and present legislative treatment and intent relating to ITC legislation.

Exhibit A

POTENTIAL EFFECT OF TAX REFORM ON INVESTMENT TAX CREDIT (ITC) CARRYFORWARDS

IF YOU INVEST $100 IN A CAPITAL ASSET IN 1986 OR EARLIER, AND CLAIMED ITC IN 1986.

DEPRECIATION BASIS ADJUSTMENT		ITC	
$100.00	BASIS	$100.00	BASIS
($ 10.00)	BASIS ADJUSTMENT	10%	ITC
$ 90.00	ADJUSTED BASIS	$ 10.00	ITC

IF YOU MADE THE SAME INVESTMENT IN TRANSITION PROPERTY IN 1987 OR 1988.

CREDIT TAKEN	DEPRECIATION BASIS ADJUSTMENT		ITC	
1987	$100.00	BASIS	$100.00	BASIS
	($ 8.25)	BASIS ADJUSTMENT	8.25%	ITC
	$ 91.75	ADJUSTED BASIS	$ 8.25	ITC
1988	$100.00	BASIS	$100.00	BASIS
	($ 6.50)	BASIS ADJUSTMENT	6.50%	ITC
	$ 93.50	ADJUSTED BASIS	$ 6.50	ITC

IF YOU HAVE AN ITC CARRYFORWARD FROM 1986 AND CLAIM IT IN 1987 OR 1988.

CREDIT TAKEN	DEPRECIATION BASIS ADJUSTMENT		ITC	
1987	$100.00	BASIS	$100.00	BASIS
	($ 10.00)	BASIS ADJUSTMENT	8.25%	ITC
	$ 90.00	ADJUSTED BASIS	$ 8.25	ITC
	$1.75	NON DEPRECIABLE BASIS		
1988	$100.00	BASIS	$100.00	BASIS
	($ 10.00)	BASIS ADJUSTMENT	6.50%	ITC
	$ 90.00	ADJUSTED BASIS	$ 6.50	ITC
	$3.50	NON DEPRECIABLE BASIS		

Exhibit B

SUGGESTED CORRECTION

Section 49(c) of the Internal Revenue Code of 1986 is amended to read as follows: (emphasis added for new language)

(c) 35-percent Reduction In Credit for Taxable Years after 1986 -

(1) Reduction in Current Year Investment Credit -- Any portion of the current year business credit under section 38(b) for any taxable year beginning after June 30, 1987, which is attributable to the regular investment credit shall be reduced by 35 percent.

(2) Unexpired Carryforwards to First Taxable Year Beginning After June 30, 1987 -- Any portion of the business credit carryforward under section 38(a)(1) attributable to the regular investment credit which has not expired as of the close of the taxable year preceding the first taxable year of the taxpayer beginning after June 30, 1987, shall be reduced by 35 percent. And The Basis Of The Property To Which The Business Credit Carryforward is Attributable Shall Be Increased Under Regulations Prescribed By The Secretary By An Amount Equal To the Product Of --

(i) 35 percent, And

(ii) The Basis Adjustment Required By Section 48(q) In The Year The Property Is Placed In Service, And

(iii) The Percentage Of The Regular Percentage Determined Under Section 46(a)(1) Which Is Treated Under This Subsection As A Carryforward.

(3) Special Rule For Taxable Years Beginning Before And Ending After July 1, 1987 -- In the case of any taxable year beginning before and ending after July 1987 --

(A) any portion of the current year business credit under section 38(b) for such taxable year, or

(B) any portion of the business credit carryforward under section 38(a)(1) to such year, which is attributable to the regular investment credit shall be reduced by the applicable percentage. And The Basis Of The Property To Which The Business Credit Carryforward Is Attributable Shall Be Increased Under Regulations Prescribed By The Secretary In The Manner Described In Subsection (c)(2) Of This Section. Except That The Subsection (c)(2)(1) Shall Be Replaced With The Applicable Percentage.

Such Basis Adjustment Shall Not Be Made, Under Regulations Prescribed By The Secretary, With Respect To That Portion Of The Credit Allowed Under Section 38(a) Which Is Carried Forward To The First Taxable Beginning After June 30, 1987.

(4) Treatment of Disallowed Credit --

(A) In General -- The amount of the reduction of the regular investment credit under paragraphs (1) and (2) shall not be allowed as a credit for any taxable year.

(B) No Carryback For Year Straddling July 1, 1987; Gross up of Carryforwards -- The amount of the reduction of the regular investment credit under paragraph (3) --

(i) may not be carried back to any taxable year, but

(ii) shall be added to the carryforwards from the taxable year before applying paragraph (2), And The Basis Adjustment Required By Section 48(q)(1) To Property Placed In Service In The Taxable Year Beginning Before And Ending After July 1, 1987, Shall Be Added Back. Under Regulations Prescribed By The Secretary, With Respect To That Portion Of The Property For Which The Regular Investment Credit Is Carried Forward To The First Taxable Year Beginning After June 30, 1987.

(5) Definition and Special Rules -- For purposes of this subsection --

(A) Applicable Percentage - The term "applicable percentage" means, with respect to a taxable year beginning before and ending after July 1, 1987, the percentage which bears the same ratio to 35 percent as --

(i) the number of months in such taxable year after June 30, 1987, bears to

(ii) the number of months in such taxable year.

(B) Regular Investment Credit --

(i) In General -- The term "regular investment credit" has the meaning given such term by section 48(o).

(ii) Exception for Timber Property -- The term regular investment credit" shall not include any portion of the regular investment credit which is attributable to section 38 property described in section 48(a)(1)(F).

(C) Portion of Credits Attributable to Regular Investment Credit -- The portion of any current year business credit or business credit carryforward which is attributable to the regular investment credit shall be determined on the basis that the regular investment credit is used first.

5977 Millstone Run
Stone Mountain, GA 30087

July 15, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: HR 2636, Technical Corrections to the 1986 Tax Act

Dear: Mr. Leonard:

Enclosed are comments concerning technical corrections to IRC Sec. 49(e) as added by the Tax Reform Act of 1986. The comments include:

1) A statement of transition property rules, and a comparison to transition property rules for termination of investment tax credit under the Tax Reform Act of 1969;

2) Examples of the effect ofthe rules as they stand; and

3) Suggested wording for correction.

If you would like to discuss further, I may be reached at (404) 666-3251. Thank you for your consideration.

Sincerely,

Beverly M. Holmes
Certified Public Accountant

pb
Enclosures

TRANSITION RULES FOR TERMINATION OF INVESTMENT TAX CREDIT

Inconsistency In 1986 Tax Reform Act

There appears to be an inconsistency in the transition rules for investment credit under the Tax Reform Act of 1986.

Under the "binding contract rule" dollars spent in 1986 which were subject to a binding contract at 12-31-85 qualify for ITC. The dollars qualify even if construction had not begun by 12-31-85, or if the amount subject to binding contract did not constitute 5% or $1,000,000 of the completed property.

On the other hand, there is no provision for allowing the investment tax credit on amounts actually spent at 12-31-85 if construction had not begun by 12-31-85, or if the amount spent did not constitute 5% or $1,000,000 of the completed property.

The result is ITC on an amount owed at 12-31-85, but no ITC on an amount paid by 12-31-85 even if all other circumstances are equal.

Rules Of 1986 Tax Reform Act

The termination of investment credit under the Tax Reform Act of 1986, as stated in IRC Sec. 49(e)(1), provides that investment credit shall not apply to any property **PLACED IN SERVICE** after December 31, 1985 except for:

1) Property subject to a written, binding contract on December 31, 1985,

2) Constructed property on which 5% or $1,000,000 had been spent or incurred at 12-31-85 and on which construction had begun at 12-31-85, or

3) An equipped building or plant facility if construction had begun as of 12-31-85, under a written specific plan, and more than 50% of the cost had been spent or incurred by 12-31-85.

Rules Of ITC Repeal Under 1986 Tax Reform Act

The termination of investment credit under the Tax Reform Act of 1969, as stated in IRC Sec. 49 (repealed in 1978), provided that investment credit did not apply to property on which **CONSTRUCTION BEGAN** after April 18, 1969 or which was **ACQUIRED** by the taxpayer after April 18, 1968, except for:

1) Property subject to a written, binding contract on April 18, 1969, OR

2) An equipped building or a plant facility if construction had begun as of 4-18-69, under a written specific plan, and more than 50% of the cost had been spent or incurred by 4-18-69.

Comparison

The rules under the 1969 repeal are, of course, much less stringent than the 1986 repeal rules. When the wording of the 1969 Act was changed for the 1986 Act to qualify a total project only if 5% or $1,000,000 was spent or incurred, surely the intent was not to deny ITC on those dollars already expended at the cutoff date.

EXAMPLE OF EFFECT OF INVESTMENT CREDIT TRANSITION RULES

To illustrate the inconsistency, assume that Company A has **SPENT** $100,000 at 12-31-85 for components to be used in construction of equipment. The total cost of the equipment closing to plant in 1986 is $2,100,000. Result: No investment tax credit on any part of the job, because the 5% or $1,000,000 test at 12-31-85 has not been met.

Now assume that Company B has **ORDERED** $100,000 of the same components to construct the same kind of equipment. For Company B the total cost of the equipment closing to plant in 1986 is also $2,100,000. Result: Company B is entitled to ITC on the $100,000 commitment.

POSSIBLE WORDING TO CORRECT ITC TRANSITION RULES

Addition to list of exceptions to non-transition property:

(4) any component part of a larger property to the extent of expenditures made at 12/31/85.

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July 16, 1987

FEDERAL EXPRESS

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: HR 2636

Dear Mr. Leonard:

I am writing to call to your attention the need for a technical correction with regard to the application of Section 47 of the 1986 Code to involuntary dispositions of Section 38 property.

Under the 1954 Code, if a taxpayer's Section 38 property is destroyed or stolen during the period provided in Section 47, there is ITC recapture. This rule continues under the 1986 Code, even though the taxpayer is no longer able to obtain an offsetting credit by acquiring replacement property.

I doubt that this result was intended. Following the last repeal of the credit, in 1969, such dispositions were treated as exempt from recapture by Section 1.47-3(c)(1) of the Treasury Regulations. However, such an exemption appears beyond the scope of those enumerated in Section 47.

Accordingly, I suggest that an additional paragraph (8) be added to Section 102(e) of HR 2636 as follows:

> (8) Section 47(b) of the 1986 Code is amended by adding at the end thereof the following new paragraph:
>
> > (4) Property which, after December 31, 1985, is disposed of or otherwise ceases to be Section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck or other casualty, or by reason of theft.

Thank you for your consideration of this proposal. Please feel free to contact me with any thoughts or questions you may have.

Sincerely,

Forrest David Milder

STATEMENT BY
NEW YORK STATE ELECTRIC & GAS CORPORATION
TO THE
COMMITTEE ON WAYS AND MEANS
ON THE
TECHNICAL CORRECTIONS ACT OF 1987 --H.R. 2636
July 16, 1987

New York State Electric & Gas Corporation ("NYSEG") appreciates the opportunity to submit written comments regarding H.R. 2636, the Technical Corrections Act of 1987.

NYSEG is one of seven major electric and gas utilities in New York State. We serve more than one-third of the State's land area. Our service area is predominantly suburban and rural in character. It covers 17,000 square miles, including all or parts of 43 counties and a population of 1,800,000. Much of our service territory is adjacent to large metropolitan areas.

NYSEG is primarily concerned with Section 102(e)(4) of H.R. 2636, regarding the proposed 35 percent reduction of investment credit carryovers where the property that gave rise to the credits was placed in service prior to January 1, 1986.

Section 211(e)(1) of the Tax Reform Act (the "Act"), regarding effective dates for the repeal of the regular investment credit, currently reads as follows:

> IN GENERAL -- Except as provided in this subsection, the amendments made by this section shall apply to property placed in service after December 31, 1985, in taxable years ending after such date.

With respect to the reductions in the face value of investment credits of 17.5 percentage points as of January 1, 1987 and an additional 17.5 percentage points as of January 1, 1988, many people interpret Act Section 211 (e)(1) to mean that unused investment credits carried forward into years after 1986, which investment credits relate to property placed in service prior to January 1, 1986, are not subject to either of the reductions. However, under Section 102(e)(4) of H.R. 2636, those reductions would apply to ITC carryforwards used in a taxable year ending after June 30, 1987, irrespective of when the property with respect to which the credit was placed in service. We believe that any such reductions would be inappropriate.

Every business that had an investment credit carryover as of December 31, 1986 would be subject to reduction of its pre-1986 ITC carryover. Generally, a business with significant unused investment credits is not in the healthiest financial condition and often was harmed more by the Act than were other businesses. Furthermore, such an amendment would be particularly harmful to businesses with large construction programs.

For example, NYSEG has approximately $29 million of unused investment credits which relate to its Somerset generating station placed in service in August of 1984. Reducing these credit carryforwards by 35-percent will create a need for additional financing in order to replace the cash. This will increase the upward pressure on electric rates.

This unnecessary rate hike would be in addition to NYSEG's recent request of the New York Public Service Commission to let us increase our electric rates in January 1988 by 4 percent to pay part of our costs for the Nine Mile Point 2 (NMP2) nuclear plant scheduled for commercial operation early next year.

Moreover, in the first quarter of this year, we wrote-off the costs for both NMP2 and the Jamesport nuclear project which will not be recovered from customers. As a result, $294 million (after allowing for the effect of federal income taxes) was charged to expense, effective March 31, 1987. This write-off, which follows recent changes in accounting rules, has a significant impact on NYSEG's earnings. For the 12 months ended March 31, 1987 NYSEG reported a loss of $1.59 per common share of stock compared to earnings of $3.86 per share for calendar 1986.

To change what many people believed to be the rules of operation by amending Act Sec. 211 (e)(1) to subject all investment credit carryovers to the reductions is wrong. Such an amendment would not only place an unnecessary financial burden on our customers, but would result in many people having been mislead in doing both financial and tax planning.

Obviously, many businesses, in calculating their first quarter estimated federal income tax payment for the year 1987 and in reporting data to shareholders and to the Securities and Exchange Commission, assumed that, pursuant to the plain language of Act Section 211(e)(1), there was no reduction in the pre-1986 ITCs. To reverse gears now could mean an understatement of income tax liability by many millions of dollars by a business.

Thus, Act Section(e)(1) should not be amended to provide that the reductions apply to all investment credit carryovers, irrespective of when the related property was placed in service.

RICHARD P. FAGAN
Comptroller

Section 212

ALEX McMILLAN
9TH DISTRICT
NORTH CAROLINA

COMMITTEE ASSIGNMENTS
BANKING, FINANCE AND
URBAN AFFAIRS
COMMITTEE

JOINT ECONOMIC COMMITTEE

SMALL BUSINESS COMMITTEE

TASK FORCE
ON TRADE AND
COMPETITIVENESS

CHAIRMAN, TASK FORCE
ON DEFENSE

Congreſs of the United States
House of Representatives
Washington, DC 20515

July 17, 1987

Mr. Joseph K. Dowley
Chief Counsel
Committee on Ways and Means
Room 1102 LHOB
INSIDE MAIL
Washington, D.C. 20515

Dear Mr. Dowley:

Enclosed are six copies of the comments of Georgetown Steel Corporation on the H.R. 2636, the Technical Corrections Act of 1987.

Sincerely,
Alex McMiller
Alex McMillan
Member of Congress

AM/fhh

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BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

RE: REQUEST FOR PUBLIC COMMENTS ON H.R. 2636,
THE TECHNICAL CORRECTIONS ACT OF 1987

COMMENTS OF GEORGETOWN STEEL CORPORATION ON
SECTION 102(f) OF H.R. 2636,
(Section 212 of the Tax Reform Act of 1986)

Submitted by Charles Owen Verrill, Jr.
Wiley, Rein & Fielding
1776 K Street, N.W.
Washington, D.C. 20006

Georgetown Steel Corporation ("Georgetown Steel"), is one of several U.S. steel minimills established in the late 1960s. Steel minimills account for twenty percent of the raw steel currently produced in the U.S. and are recognized as mounting the first significant challenge to steel imports in recent times.[1] Their growth and success is based primarily on investment and reinvestment in new technologies -- the very activity which Section 212 of the Tax Reform Act of 1986 seeks to encourage.[2]

In spite of this fact, steel minimills are not eligible for the benefits of Section 212. Only those steel companies whose 1983 raw steel production in the U.S. exceeded 1.5 million net tons are eligible to use Section 212.

Georgetown Steel proposes that H.R. 2636 be amended to include a provision to provide equitable treatment to steel minimills excluded from the 15-year carryback provision of Section 212. Its proposal is quite simple: extend the carryforward period for eligible steel minimills (defined as those companies who received 50 percent or more of their gross receipts in the years in which unused ITC credits were generated from the melting, rolling, or fabricating of steel products) to an unlimited period.

BACKGROUND

Section 212 of the Tax Reform Act of 1986 provides a limited 15-year carryback (rather than the normal 3-year carryback) of unused investment tax credits (ITC) to eligible steel companies. Under this provision, unused ITCs are refunded by authorized amendments to the tax returns of eligible steel companies in the carryback period. The benefit is limited to the lesser of 50% of the existing carryforward or the net tax liability for the period.

Companies eligible for this benefit are required to commit the funds received from their carrybacks to "reinvestment in and modernization of the steel industry".[3] However, as noted above, the bill's definition of eligible steel companies excludes steel minimills -- the very companies which have been complying with the bill's reinvestment requirements.

---

[1] D. Barnett & R. Crandall, Up from the Ashes, The Rise of the Steel Minimill in the United States 16 (1986).

[2] Section 212(f) requires steel companies eligible for a fifteen carryback of their investment tax credits to commit the funds received from such credits to "reinvestment in and modernization of the steel industry . . .".

[3] Tax Reform Act of 1986, Pub. L. No. 99-514, (212(f), 100 Stat. 2085, 2171.

HISTORY OF THE INVESTMENT TAX CREDIT

The investment credit, first enacted in 1962, was designed by Congress to increase expansion and modernization of the nation's productive facilities, thereby improving the economic potential of the country and obtaining sustained, full employment.

In 1966, as part of an anti-inflationary program, Congress suspended the investment credit for fifteen months. However, after five months, the credit was restored. In 1969, Congress, based on the 1966 rationale, again repealed the credit.

Then, in 1971, the investment credit, referred to as the "job development credit," was reinstated. The House Ways and Means Committee Report on the Tax Revenue Act of 1971 stated that the "lagging investment in machinery and equipment [was] one of the principal causes of the . . . depressed economic conditions" existing at that time. Therefore, the job development credit was enacted to "bolster the economy and create additional jobs by encouraging expenditures on machinery and equipment."

Thereafter, the investment credit, with computational modifications (*i.e.*, rate of the credit, basis adjustment, qualifying property, etc.) remained "on the books" until repealed by the Tax Reform Act of 1986 (H.R. 3838).

INTENT OF SECTION 212

Prior to the Tax Reform Act of 1986, refunds of unused ITCs were not authorized. Because of the crisis brought about by a surge in steel imports beginning in 1980-81, many steel companies experienced losses and accumulated unutilized credits. Section 212 is intended to allow steel companies to obtain a refund of unutilized ITCs. However, the eligibility for refundability was limited to companies whose production exceeded 1.5 million tons in 1983. This capacity restriction was adopted solely for revenue purposes -- by restricting Section 212 to large steel companies its estimated cost to the Federal Government was $500 million rather than the several billion dollar cost estimated if its benefits were available to *all* steel companies.

INEQUITABLE EFFECT OF SECTION 212

The limitation of the carryback benefits to large steel producers is inequitable for several reasons:

1. *It discriminates against efficient steel producers, most of which are minimills.* It is the steel minimills that have provided most of the technological innovations over the last 10 years to the U. S. steel industry. (Georgetown Steel, for example, introduced continuous casting of billets to the wire rod industry, a technology that is now universally accepted as the most cost efficient.) These new technologies required continued investment at a time of "steel crisis" and resulted in unutilized ITCs that small steel companies may now lose before they can be offset against future tax liability.

2. *Section 212 discriminates against startup companies.* A steel company in its initial years will normally not be in a tax-paying position. However, such companies are normally

innovative and on the cutting edge of the technology evolution.

3. Section 212 discriminates against non-diversified product steel producers. Many small producers do not have subsidiaries whose businesses are diversified into areas other than steel production which may provide taxable liability against which to utilize investment credit carrybacks. Hence, the companies that are solely investing in the modernization and revitalization of the U.S. steel industry, are penalized by this provision.

4. Restricting the benefits of Section 212 to large steel producers penalizes the very companies who have carried out the intent of the investment tax credit -- to wit, investment in modernization and research and development. The minimills have made investments in equipment and technological developments, as encouraged by the investment credit. Yet, Section 212 precludes them from benefitting from their compliance with the purpose and intent of the law.

PROPOSAL TO PROVIDE EQUITABLE TREATMENT FOR SMALL PRODUCERS

Georgetown Steel proposes that H.R. 2636 be amended to include a provision to provide equitable treatment to steel minimills excluded from the 15-year carryback provision of Section 212 by extending the carryforward period for their investment tax credits to an unlimited period. Proposed legislative language for this amendment reads as follows:

> "Section 212 of the Tax Reform Act of 1986 is amended by adding at the end thereof the following new subsection:
>
> > "(h) EXTENSION OF CARRYFORWARD PERIOD FOR SMALL STEEL COMPANIES.--
> >
> > > "(1) IN GENERAL.--In the case of a qualified small steel company--
> > >
> > > > "(A) there shall be no limitation on the number of taxable years to which any existing carryforward may be carried under section 39 of the Internal Revenue Code of 1986, and
> > > >
> > > > "(B) section 39(a)(2)(B) of such Code shall be applied with respect to any such carryforward as if it did not contain the figure '17'.
> > >
> > > "(2) QUALIFIED SMALL STEEL COMPANY.-- For purposes of paragraph (1), the term 'qualified small steel company' means any domestic corporation if--
> > >
> > > > "(A) such corporation is not a qualified corporation, and
> > > >
> > > > "(B) 50 percent or more of the aggregate gross receipts of such corporation for the taxable years in which the existing carryforwards arose are attributable to the melting, rolling, or fabricating of steel products included in the coverage of bilateral agreements authorized to be enforced pursuant to section 805 of the Steel Import Stabilization Act."

RATIONALE FOR PROPOSAL

The Georgetown proposal would not have the immediate revenue impact of the refundability already authorized under Section 212 for the "major" steel companies. Instead, it would simply preclude the expiration of ITCs previously earned.

Small steel companies that were denied immediate benefits under Section 212 of the TRA of 1986 are often highly leveraged precisely because they have made the investments necessary to attain the technological levels of production necessary to modern steelmaking. At the same time, these companies were adversely affected by the surge in imports that began in 1980-81 and which ultimately led to the President's Steel Program in 1984. In this context, the small steel companies logically should have been included in the coverage of Section 212.

Recognizing the revenue impact, and the fact that some small steel companies would not qualify under Section 212 because they were started up relatively recently (and, therefore, did not have past earnings), Georgetown's proposal would simply extend the life of ITCs already earned. This measure would preserve the value of unutilized ITCs without giving them immediate value as was done in the case of the major steel companies.

For the foregoing reasons, Georgetown Steel urges the Committee to include its amendment in the H.R. 2636, The Technical Corrections Act of 1987.

Dated: July 9, 1987

STATEMENT ON BEHALF OF
KAISER ALUMINUM & CHEMICAL CORPORATION

Re: Proposed Amendment to H.R. 2636 to Provide for a Refund of Investment Tax Credit Carryforwards Where Refund is Deposited in Certain Pension Plans

The Tax Reform Act of 1986 (the "1986 Act") repealed the investment tax credit (the "ITC") effective as of January 1, 1986, "devalued" ITC carryforwards from 1985 and prior years by 35 percent and placed new limitations on the use of such carryforwards to offset either the regular income tax or the alternative minimum tax in 1987 and subsequent years. In combination, these provisions of the 1987 Act in effect retroactively disallow a portion of previously earned ITCs and make it more difficult for taxpayers to use their remaining ITC carryforwards in the future. These provisions had a particular and substantial adverse impact on capital intensive corporations, including Kaiser Aluminum & Chemical Corporation ("Kaiser"), which is emerging from a period of real economic losses during which it could not fully utilize its ITCs in the years earned.

Congress recognized this problem and provided a partial remedy for some corporations. Specifically, the 1986 Act includes an elective provision under which "qualified corporations" may receive a refund of a portion of their previously earned ITCs if they agree to forego $2 of ITCs for each $1 refunded, and if they refund does not exceed the aggregate of federal income taxes paid during the preceding 15 years. However, Congress limited this provision to domestic steel companies (and provided a somewhat comparable provision for certain small farmers). For the reasons explained below, Congress should enact legislation in 1987 to extend substantially the same election to Kaiser if it agrees to deposit the full amount of the refund in those employee pension plans as to which the IRS has previously granted funding waivers.

Kaiser and its subsidiaries have for many years maintained defined benefit pension plans for their salaried and hourly employees. Contributions to such plans were made by Kaiser on or before September 15 of each year. As of January 1, 1986, 12,884 employees were participants in these defined benefit plans. In 1986, Kaiser was able to make only a partial payment to these plans and all employees were so notified on September 16, 1986. Kaiser had previously applied to the Inernal Revenue Service (the "IRS") for a funding waiver pursuant to section 412 of the Code. That provision required Kaiser to demonstrate that it would be unable to meet the funding standard without substantial business hardship and that application of the funding standard would be adverse to the plan participants in the aggregate. The IRS granted the requested waiver on September 12, 1986. Under the terms of the IRS waiver, the deferred amounts are payable in equal installments with interest over five years. (The waiver was contingent upon Kaiser's negotiation of an acceptable arrangement with the Pension Benefit Guaranty Corporation (the "PBGC") within a specified time period to provide appropriate collateral on a portion of the amount deferred).

Under the proposed legislation, Kaiser could obtain a refund of a portion of its ITC carryforwards (on the same $2 for $1 basis up to the total taxes paid in the preceding 15 year period, as under the "steel company" provision of the 1986 Act) but only if it (1) had received a funding waiver from the IRS before the date of enactment of the 1986 Act and (2) enters into an agreement with the IRS and the PBGC that the full amount of the refund received will be used within 30 days of receipt to make contributions to those defined benefit pension plans with respect to which the funding waiver was received. It is anticipated that the maximum refund that Kaiser could receive under this provision would be approximately $42 million.

The proposed legislation can be justified on both pension policy and tax policy grounds. Recent developments indicate that the ability of the PBGC to meet its insurance obligations may be open to questions and that legislation may be required to address this problem directly. The proposed legislation would contribute significantly to the ability of Kaiser to make up the funding deficits from its own resources (i.e., ITCs previously earned in accordance with prior law) and thus is consistent with the desire of Congress to minimize the pressures upon the PBGC. The proposed legislation is also reasonable as a matter of tax policy. The ITCs that would be refunded were earned by Kaiser in accordance with prior law and generally would have been used to offset taxes payable in prior years had not Kaiser sustained real economic losses in those years. Finally, the real beneficiaries of the proposed legislation will be the employees of Kaiser and not Kaiser itself (which must forego $2 of carryforwards for $1 refunded).

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INTERIOR
COMMERCE, JUSTICE, STATE,
AND JUDICIARY
DISTRICT OF COLUMBIA
SELECT COMMITTEE ON AGING
SUBCOMMITTEE
HEALTH AND LONG-TERM CARE

Congress of the United States
House of Representatives
Washington, DC 20515

July 8, 1987

The Honorable John J. Duncan
2206 Rayburn Building
Washington, D.C. 20515

Dear John:

I am in receipt of a letter from Chairman Rostenkowski concerning changes to the Technical Corrections Act of 1987, pursuant to my request as outlined in my January 22, 1987, letter to him (copy attached).

In reviewing the sections of the Act he cited, I was very disappointed to learn that modifications have not been made which would include the Timken Company of Canton, Ohio, under the investment tax credit (ITC) provisions that provide relief to our domestic steel industry under the Tax Reform Act of 1986.

As presently written, the Act qualifies only "big steel" companies (and one other company which was incorporated on February 11, 1983, in Michigan) for the effective 15 year carryback of existing carryforwards of ITC's. I strongly urge that the Timken Company be included under this provision for the following reasons:

- Following nearly three years of exhaustive study and four years of planning and construction, the Timken Company, during 1985, began fulfillment of their commitment to be the low-cost producer of the highest quality alloy steel by starting up operations in America's first new alloy steel plant in more than 30 years. The $450,000,000 investment in their Faircrest Steel Plant is an excellent example of what an American industrial company can do when provided with appropriate incentives by local, state and federal governments.

- Relying upon the tax structure existing at that time, the Timken Company has generated approximately $18,000,000 of ITC's which they will not be able to use for at least several years under existing regulations.

- While the Timken Company has not experienced the magnitude of loss incurred by other domestic steel manufacturing companies in 1986, they did have a loss before income taxes of almost $144,000,000.

- The Timken Company competes directly with most of the steel companies who, under the new tax reform law, have been granted an immediate cash inflow of one-half of their existing ITC's. Many of these companies could not ever have used all of their existing ITC's within the required 15 year carryforward period. Several even posted a financial profit in the first quarter of 1987 as a result of being included in Section 212 of the Tax Reform Act of 1986. To deny the Timken Company the same relief would deny them the opportunity to compete on an even playing field with other domestic steel producers.

For these reasons, I respectfully urge the inclusion of the following definition in Section 212(g)(1)(A) of the Technical Corrections Act of 1987: "Any United States company that invested more than $400,000,000 in new steel producing facilities during the period from January 1, 1982, through December 31, 1985, and located within the United States."

Inclusion of this definition will grant equality of treatment to a U.S. company which is responsibly attempting to compete in global markets and maintain a strong domestic steel industry. In the name of fairness, I urge this modification.

Thank you very much for your careful consideration of this request.

Sincerely,

Ralph Regula, M.C.

RR:cdh

RALPH REGULA
16TH DISTRICT, OHIO

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Congress of the United States
House of Representatives
Washington, DC 20515

COMMITTEES
APPROPRIATIONS
SUBCOMMITTEES
INTERIOR
COMMERCE, JUSTICE, STATE, AND JUDICIARY
SELECT COMMITTEE ON AGING
SUBCOMMITTEE
HEALTH AND LONG-TERM CARE

January 22, 1987

The Honorable Dan Rostenkowski
1102 Longworth HOB
Washington, D.C. 20515

Dear Mr. Chairman:

We would like to request the inclusion of two changes in the corrections bill for the Tax Reform Act of 1986.

First, we would appreciate the inclusion in the transition rules for steel companies the following definition: "Any United States company that invested more than $400 million in new steel producing facilities during the period from January 1, 1982, through December 31, 1985, and located within the United States."

This definition will permit the Timken Company, located in Canton, Ohio, to take advantage of the transition rules in the tax treatment of their new steel plant. As you know, this new plant was the only one in the U.S. built during the past five years and represents Timken's commitment to compete with the modernization efforts of our foreign competitors. It was built with reliance upon the tax structure existing at that time; therefore, including the above definition in the transition rules serves fairness and competitiveness considerations.

Second, we request, through the corrections bill, the exclusion from the gross income of landowners, benefits or payments received from any state or federal fund for the reclamation of abandoned mine lands.

A recent decision issued by the Internal Revenue Service would consider as gross income subject to federal tax any funds received from the federal or state government for reclamation on privately owned lands. Failure to provide tax exemption for privately conducted reclamation will cause private landowners to reject federal and state reclamation grants, thus invalidating the entire AML (Title IV) program.

In the interest of fairness, we respectfully request these two changes to the tax law. Thank you very much for your careful consideration of this request.

Sincerely,

Ralph Regula, M.C.

John P. Murtha, M.C.

TIMKEN

THE TIMKEN COMPANY
GENERAL OFFICES
CANTON, OHIO, U.S.A. 44706
TELEPHONE (216) 438-3000

July 7, 1987

- CERTIFIED -

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

We have received a copy of H.R. 2636, the Technical Corrections Act of 1987, and were extremely disappointed that Act Sec. 212(g)(1)(A) has not been modified as requested to include The Timken Company.

Act Sec. 212(g)(1)(A), as presently written, includes only "big steel" companies and a company which was incorporated on February 11, 1983, in Michigan as being qualified for the effective 15-year carryback of existing carryforwards of Investment Tax Credits. We strongly urge that The Timken Company also be included for the following reasons:

> Following nearly three years of exhaustive study and four years of planning and construction, The Timken Company, during 1985, began fulfilling our commitment to be the low-cost producer of the highest quality alloy steel by starting up operations in America's first new alloy steel plant in more than thirty years. The $450,000,000 investment in our Faircrest Steel Plant is an excellent example of what an American industrial company can do when provided with appropriate incentives by local, state and federal governments.
>
> Relying upon the tax structure existing at that time, we have generated approximately $18 million of Investment Tax Credits which we will not be able to use for at least several years under existing regulations.
>
> While we have not experienced the magnitude of losses of some other steel manufacturing companies, in 1986 we had a loss from operations of almost $144,000,000.
>
> We compete directly with most of the companies who have been given an immediate cash inflow of one-half of their existing Investment Tax Credit. Many of these companies could not ever have used all of the existing ITC within the required 15 year carryforward period. Several even posted a financial profit in first quarter 1987 as a result of being included in Act Sec. 212. To deny The Timken Company the same opportunity would be to deny us the opportunity to compete on even terms.

Enclosed is a copy of a letter dated January 22, 1987 from Congressmen Ralph Regula and John Murtha which requests the inclusion of the following definition in Act Sec. 212(g)(1)(A) "any United States company that invested more than $400 million in new steel producing facilities during the period from January 1, 1982, through December 31, 1985, and located within the United States."

We strongly urge that this language be incorporated in the technical corrections to the Tax Reform Act of 1986. To do otherwise would deny equality of treatment to a U.S. company which is trying to do the "right things" to enhance its ability to compete in global markets and maintain a strong domestic steel industry.

Sincerely,

G W Duggan

G. W. Duggan
Director - Taxes

Section 251:

Congreſs of the United States
House of Representatives
Washington, D.C. 20515

July 8, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

We write in response to Press Release #12, dated June 10, 1987, in which the Committee invites comments regarding H.R. 2636.

You will recall that on July 1 you met with us, Fredi Prevost of Congressman Crockett's staff, Sean Foley of Congressman Levin's staff, Susan Rogers and Janice Mays of the Committee's staff and William Brodhead regarding the Atrium Place project in Detroit. Mr. Brodhead is counsel to the City of Detroit with respect to this matter.

The Atrium Place project is a proposal to rehabilitate the old Statler Hilton Hotel, a certified historic structure, in the Grand Circus Park area of downtown Detroit, and convert the building to a 334-unit apartment building. The project is an important part of Detroit Mayor Coleman Young's effort to bring new housing to downtown Detroit and to rehabilitate a once-elegant, but now-decaying area of the City. The total project cost is approximately $40 million.

In early 1986, this project was set to go. Binding contracts were in effect with the developer, with the Downtown Detroit Development Authority, with lenders, with the architect and with the builder. The pendency of the Tax Reform Act of 1986, however, caused the project to be put "on hold", since a significant part of the financing for the project had been put together in reliance on then-existing tax laws.

Because of Congressman Crockett's concern about the importance of this project to the district which he represents and because the project seemed to him to be deserving of an appropriate transition rule, he approached Chairman Rostenkowski on the matter in late July of last year. Mr. Crockett received what he felt was a clear, direct and explicit committment that the project would be covered by an appropriate transition rule in the Tax Reform Act of 1986. Mr. Crockett confirmed this committment in his letter of August 15, 1986 to the Chairman.

Following that letter, Fredi Prevost of Congressman Crockett's staff and Mr. Brodhead met with Susan Rogers of the Committee staff and provided her with information about the project. She indicated that the project would be covered by a general transition rule for such projects. That transition rule was ultimately set forth in Section 251(d)(2) of the Act.

Section 251(d)(2) provides that projects which were completed "pursuant to a contract which was binding on March 1, 1986" would receive pre-Tax Reform Act treatment with respect to depreciation and the rehabilitation tax credit. It is that treatment which we are seeking for the Atrium Place project.

It soon became clear, however, that there were problems with the transition rule referred to above with respect to the Atrium Place Project. Local tax counsel to the developer indicated that he would be unable to issue a clear, unequivocal opinion that 251(d)(2) covered Atrium Place. He pointed out that the project was subject to a multiplicity of contracts, one or more of which could possibly be said to be contingent under certain very limited circumstances.

In addition to that problem, other unforseen problems occurred. The builder with whom the developer had a binding contract on March 1, 1986 asked to be released from his contract because the builder was unable to obtain a bond covering his work on the project. Accordingly, a new building contract, with a different builder, was executed subsequent to March 1, 1986.

There will also be a new mortgage lender. As of March 1, 1987, there was a binding contract for an $18 million mortgage with the Michigan state Housing Development Authority (MSHDA). Because of the long delay in starting the project, due in part to the pendency of the Tax Reform Act, it became possible to secure a mortgage coinsured by H.U.D. on more favorable terms than the earlier mortgage with MSHDA. A binding contract for such a mortgage is now in place.

For all of these reasons, it is not possible to say for certain that the Atrium Place project is in fact covered by the transition rule in 251(d)(2).

The fact remains, however, that the project was, in good faith, set to go on March 1, 1986. The fact also remains that it seems clear that it was the intent of the Conferees on the Tax Reform Act to see that the Atrium Place project would be covered by an appropriate transition rule. The project remains the same -- location, purpose, plan, design, and in most of the contracts, including the umbrella agreement between the developer and the city.

For these reasons, we respectfully request that a so-called "rifle-shot" transition rule for the Atrium Place project in Detroit be contained within the appropriate section of H.R. 2636, the proposed Technical Corrections Act.

The proper place for insertion of such a "rifle-shot" transition rule would appear to be at line 17 on page 53 of the Technical Corrections Act after the words "(QQ) Springville Mill Project, Rockville, Connecticut".

We would suggest that the project be described as follows: "Atrium Place, Detroit Michigan".

If we can supply any additional information on the project, we would be pleased to do so.

Sincerely,

Geo. W. Crockett, Jr.
Member of Congress

Sander Levin
Member of Congress

cc: Susan Rogers
Janice Mays
Ways and Means Committee
William M. Brodhead

GWC:fjp

STATEMENT OF JAMES X. MULLEN

BEFORE THE COMMITTEE ON WAYS AND MEANS

H.R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987

JULY 6, 1987

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to present to the Committee the case for a technical correction to the Tax Reform Act of 1986 for inclusion in the Technical Corrections Act of 1987, H.R. 2636.

The Tax Reform Act of 1986 eliminated the investment tax credit and, in addition, modified allowances for the rehabilitation credit for qualifying property, making the new rehabilitation credit generally less valuable than before. Unfortunately, and I believe inadvertently, the bill did not include a provision that has historically been used to prevent unfairness to a taxpayer who suffers a casualty loss (theft, damage, or destruction) to section 38 property which was previously placed in service, and which was eligible for ITC or other credit. In general, a casualty loss is a "conversion" which triggers recapture of previously-allowed credits under Code section 47, and thus after TRA-86 a taxpayer can suffer not only the economic loss of a casualty, but also a potentially large tax penalty because of this credit recapture. I and my advisors believe this "disaster tax" was an inadvertent result of the Tax Reform Act of 1986, and that upon consideration of this issue, Congress would have enacted an exception (adopted by Congress in previous similar situations) under which there would be no recapture of investment credit and rehabilitation credit in the event of a casualty loss.

On March 31, 1987, property owned by me and occupied 100% by my closely held corporation, Mullen Advertising, Inc., was totally destroyed by fire. Previously, I had acquired and totally rehabilitated the property qualifying for the rehabilitation credit for commercial property and took occupancy in December, 1985. I also acquired a significant amount of furniture and equipment during that period qualifying for investment credit.

As a result of the fire loss and in accordance with the Tax Reform Act of 1986 and previous tax legislation, it is now necessary for me to recapture approximately $126,000 of rehabilitation credit as well as $25,000 of investment tax credit. The recapture of these tax credits will add to already serious financial and cash flow problems for my business and me as a result of the fire.

On the day of the fire I found myself having to explain to some sixty employees there was no place for them to work, all of the materials they were previously working with had been totally destroyed and the bulk of financial records, property owned by clients, property owned by subcontractors (such as original photographs, etc.) had been totally destroyed.

We now have temporary space to allow the business to continue and have already started the process of reconstructing lost records. The disruption to my business has been crippling and extremely costly not only from the differential between the insurance limits and the replacement value of the property and equipment; but also we must replace or pay for records and materials of others not insured.

Not including the uninsured recapture of tax credit, the aftermath of the fire loss will have cost both myself and the corporation tens of thousands of dollars beyond insurance coverage. The most tragic aspect is, of course, the many personal items and memorabilia in the facility at the time of the fire that can never be replaced.

It is important to understand that the major loss was that of the building, a beautiful turn of the century facility which had been totally rehabilitated at a cost in excess of $2 million which could never have been insured for its true value. Further, the replacement of the building as well as the furniture and fixtures is now estimated to be $5,250,000 and will not qualify for the rehabilitation credit as previously allowed or investment tax credit eliminated by the Tax Reform Act of 1986.

Historically, an exception did exist to exclude recapture of tax credits lost as a result of a casualty loss. A brief history of previous law follows:

1) In 1969, when the then-existing investment tax credit was repealed, this problem was expressly addressed with statutory transition relief. In particular, a transitional rule provided that where, because of the termination of the investment credit, the taxpayer could not avoid the effects of recapture by acquiring new property (since the investment credit at that time was no longer available), the recapture rules did not apply. Amended code section 47(a)(4) (hereinafter "former section 47 (a)(4)") at that time read as follows:

> "(4) Property destroyed by casualty, etc.--No increase shall be made under paragraph (1) and no adjustment shall be made under paragraph (3) in any case in which--
>
> "(A) any property is disposed of, or otherwise ceases to be Sec. 38 property with respect to the taxpayer, on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft,
>
> "(B) section 38 property is placed in service by the taxpayer to replace the property described in subparagraph (A), and
>
> "(C) the reduction in basis or cost of such section 38 property described in the first sentence of section 46(c)(4) is equal to or greater than the reduction in qualified investment which (but for this paragraph) would be made by reason of the substitution required by paragraph (1) with respect to the property described in subparagraph (A).
>
> "Subparagraph (B) and (C) shall not apply with respect to any casualty or theft occurring after April 18, 1969." (emphasis added)

2) When the investment tax credit was reintroduced by the Revenue Act of 1971, this statutory exception was eliminated, and Sec. 107(a)(1) of P.L. 92-178 repealed Code Sec. 47(a)(4). The committee report to the Revenue Act of 1971, P.L. 92-178, states:

> "Your committee concluded that, since the investment credit is being restored -- with the result that the replacement property is eligible for the credit - there is no reason to continue any exceptions to the recapture rules."

Although the rehabilitation credit did not exist in the tax law at that time, it is clear that Congress' intent was to provide an exception for tax credit recapture resulting from casualty loss. Therefore, I am requesting an exception be included in the Technical Corrections Act of 1987 to provide for exclusion for the recapture of tax credits resulting from involuntary conversions. Attachment A is the proposed wording for this provision.

We believe the proposed provision would not entail significant revenue loss since the most significant revenue impact would be in the relatively unusual situation where very new equipment or property (1-2 years in service at most) was destroyed by casualty. For example, equipment placed in service in the early to 1980's would have little or no recapture in 1987, under Code section 47, while equipment placed in service in 1985 or 1986 would cease to generate recapture 3 to 5 years (depending on the class of equipment) after it was placed in service. Ultimately, even if there is a revenue loss in 1987, 1988 or 1989, this "loss" is merely a decision not to apply what amounts to an affirmative tax on individuals and companies that suffer casualty disasters. Obviously, in seeking necessary and proper sources of tax revenues, Congress should place victims of casualty disasters at the bottom of its list, and not at the top as TRA-86 has done.

Also attached is a list of potential witnesses which may be called upon to testify as to the validity of this legislation.

We very much hope the Committee will recognize the issues we have outlined, and approve the amendment we have suggested.

ATTACHMENT A

Proposed Code Section 47(a)(6)

"(6) Property destroyed by casualty, etc.--No increase shall be made under paragraph (1) or under paragraph (5) in any case in which--

> "(A) any property is disposed of, or otherwise ceases to be Sec.38 property with respect to the taxpayer, on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft,
>
> "(B) section 38 property is placed in service by the taxpayer to replace the property described in subparagraph (A), in a transaction that qualifies for non-recognition of all gain under section 1033(a)(2), and
>
> "(C) the basis of such section 38 property is determined under the rules set forth in section 1033(b).

"In the event replacement property described in subparagraph (B) and (C) is eligible for credits determined under Code section 46, such credit amount shall be reduced, but not below zero, by the amount of any increase in tax which would otherwise be required but for the application of this paragraph."

Section 252

COMMENTS BY ASSOCIATED FINANCIAL CORPORATION

BACKGROUND STATEMENT

This paper proposes technical corrections and substantive amendments to section 42 and related provisions of the Internal Revenue Code of 1986 (the "Code") dealing with the low-income housing credit. The low-income housing credit, which was enacted as part of the Tax Reform Act of 1986, was designed to replace the multiple tax preferences for investment in low-income housing that existed under prior law. Congress believed that the credit was a more efficient mechanism for encouraging private sector investment in low-income housing projects.*

Unfortunately, a variety of problems with the original statute have arisen, many of which will be alleviated if the recently introduced technical corrections bill (H.R. 2636; S. 1350) is enacted in its present form. Particularly noteworthy in this regard are those provisions of the bill which:

- Waive the "secured by the . . . building" requirement of section 42(k)(2)(B) for otherwise qualifying debt in situations where a security interest in the building is not allowed by the Federal agency holding or insuring the first mortgage and the "proceeds" from the unsecured financing are applied to acquire or improve the building (although this provision should be amended to confirm that it applies to purchase money and other acquisition indebtedness).

- Allow taxpayers to elect to determine the credit amount, based on interest rates existing at the time of investment, before the building is placed in service.

- Allow projects to be eligible for credits allocated in the previous year if the project was delayed "for reasons unforeseen and beyond the control of the taxpayer."

- Provide exceptions, mainly in cases of foreclosures and acquisitions by government and qualified nonprofit entities, to the general rule that buildings are not eligible for the credit if they had previously been placed in service within ten years of the acquisition date.

- Make partnerships, rather than individual partners, subject to the recapture of credits so long as 50% or more of the partnership is owned by at least 35 natural persons or estates.

While we endorse and recommend the adoption of the foregoing provisions, the technical corrections bill still fails to address several significant statutory deficiencies which, to date, have inhibited the effective implementation of the credit program. The proposals recommended below seek to remedy these statutory deficiencies with the desired goal of making the credit program more workable administratively, thus ensuring that it will achieve its intended purpose of providing decent and affordable housing to low and moderate income families.

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* For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1413; S. Rep. No. 99-313, pp 757-768; Senate Floor Amendment, 132 Cong. Rec. S8146-8158 (June 23, 1986); and H. Rep. No. 99-841, Vol. II (Sept. 18, 1986), pp. 85-103 (Conference Report).

PROPOSED STATUTORY AMENDMENTS AND REASONS THEREFOR

I. Section 708(b)(1)(B) Terminations

A. Statutory Change. To treat purchases of partnership interests that cause section 708(b)(1)(B) terminations as purchases of the underlying assets--

Subsection (d) of section 42 is amended by adding to the end thereof the following paragraph:

> (8) Certain Purchases of Partnership Interests.--
>
> (A) In General.--For purposes of determining the eligible basis of an existing building, the purchase by a person or persons, in a single transaction or a set of interdependent transactions, of the capital and profits interest of a section 42 partnership sufficient to cause a termination of such partnership pursuant to section 708(b)(1)(B) shall be treated under this section as a purchase by such partnership of the assets held by such partnership.
>
> (B) Application of Paragraph (2)(B).--In the event of a transaction or set of transactions described in subparagraph (A), the following will apply in determining whether the requirements of paragraph (2)(B) of this subsection have been met--
>
> (i) Section 179(d)(2).--For purposes of applying section 179(d)(2)(A) and (C), the person or persons acquiring the interest in the section 42 partnership shall be treated as the person acquiring the property and the person or persons from whom the interest in the section 42 partnership is acquired shall be treated as the person from whom the property is acquired.
>
> (ii) Previously Placed in Service.--For purposes of applying paragraph (2)(B)(ii) and (iii), the person or persons acquiring the interest in the section 42 partnership shall be treated as the taxpayer.
>
> (C) Limitation.--This paragraph shall only apply to that portion of the

acquisition cost attributable to the purchase described in subparagraph (A) incurred by, and the benefits of this section shall only be allocated to, those persons who purchased an interest in the section 42 partnership in a transaction described in subparagraph (A) and whose relationship to the person or persons from whom such interest is acquired is not described in section 179(d)(2)(A) (as modified by paragraph (2)(D)(iii)(I) of this subsection).

(D) Section 42 Partnership.--The term "section 42 partnership" refers to any partnership if, at the time of its termination under section 708(b)(1)(B), 80% or more of the gross value of its assets consist of--

(i) a building or buildings consisting of residential rental units,

(ii) money and other property (including land) incidental to the operation of the building or buildings described in clause (i), and

(iii) investments in a section 42 partnership or partnerships (held directly or indirectly through a tiered partnership arrangement).

B. Reason For Change. Section 901 of the Housing and Urban Development Act of 1968, 82 Stat. 476, 507 (the "1968 Act"), declares "that it is the policy of the United States to encourage the widest possible participation of private enterprise in the provision of housing for low or moderate income families." To accomplish this task, the 1968 Act contemplated the formation of partnerships as the preferred vehicle for facilitating private sector investment in housing projects. See S. Rep. No. 1123, 90th Cong., 2d Sess. 85 (1968). See also 114 Cong. Rec. 14946, 15136 and 15241 (1968). While Congress was cognizant of this fact when it enacted the low-income housing credit provisions,* it failed to provide adequate guidance as to the application of the credit in situations where investments are made through partnerships or other flow-through entities.

In acquiring an interest in a low-income housing building, there are oftentimes legitimate, non-tax reasons for purchasing partnership interests rather than acquiring a direct interest in the building itself. For example, a direct transfer of the building may invoke a due-on-sale provision under an existing mortgage or otherwise be barred by contractual provisions requiring the consent of an adverse partner often owning rights to only a small portion of the building. In such cases, the investor would typically purchase a majority position in the partnership, thus resulting in a constructive termination of the partnership under Code section 708(b)(1)(B).

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* See, e.g., Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, p.154, n.3.

Upon a section 708(b)(1)(B) termination, the partnership is viewed as having made a constructive liquidating distribution of its assets to the partners (including the new investor), followed immediately thereafter by a constructive contribution of the same assets back to the partnership. This mechanized view of the transaction permits the investor to obtain a basis in his share of the partnership's assets equal to the tax basis of his newly acquired partnership interests. It is clear that the intent behind a section 708(b)(1)(B) termination is to treat the purchase of a majority interest in a partnership as tantamount to a direct purchase of a proportional interest in its assets. See, e.g., McCaulsen v. Commissioner, 45 T.C. 588 (1966).

The current operation of Code section 42(d) casts serious doubts as to whether the credit is available in situations where the acquisition involves the purchase of a controlling partnership interest. For instance, the following questions are raised by such a transaction:

a. Whether the "purchase" requirement of section 42(d)(2)(B)(i) is satisfied insofar as section 179(d)(2)(A) excludes from the definition of "purchase" acquisitions from a person who owns a 10 percent or greater interest in the acquiring partnership and this requirement would be technically violated upon the partners' deemed contribution of the building back to the partnership upon its constructive termination.

b. Whether the prohibition against acquisitions from related parties contained in section 42(d)(2)(B)(iii) will be contravened since both the partnership and its partners may be considered related at the time of the partnership's constructive liquidation (i.e., the theoretical time in which the building is placed in service by the partners).

c. Whether the building would be placed in service by the partners (i.e., upon the constructive liquidation of the partnership) within the last ten years, thus running afoul of the requirement in section 42(d)(2)(B)(ii).

The proposed statutory changes would remove these uncertainties, thus enabling investments in qualifying projects to be made by way of a partnership acquisition. The benefits to be derived from such an acquisition would be allocated solely to the purchasing entity rather than the existing partners. This would alleviate what, for many existing projects, has been a significant impediment to the attraction of badly needed capital.

II. "Purchase" Requirement Determined at Time Building Placed in Service

A. Statutory Change. To clarify that the determination of whether a "purchase" has occurred should take place at the time the building is acquired for purposes of claiming the credit--

> Subclause (I) of section 42(d)(2)(D)(iii) is amended by inserting before the period "and the determination under section 179(d)(2)(A) shall be made at the time the building is acquired by the taxpayer."

B. Reason For Change. For purposes of determining whether a low-income building was acquired from a "related person," section 42(d)(2)(D)(iii) should be amended to make it clear that the 10% ownership rule is to be applied at the time the building is acquired. As the statute now reads, it is possible to interpret the 10% rule as applying at any time during the 15-year compliance period. Such a construction would create investor uncertainty as to whether previously allocated credits will be recaptured upon the acquisition by a "related person" (through inadvertance or otherwise) of an impermissible interest in an investment entity. This uncertainty, in turn, could impact negatively on the investor's willingness to participate in a low-income housing program.

III. At-Risk Rules

A(1) Statutory Change. To provide for consistency between basis for section 42 and section 465 purposes--

> Paragraph (6) of section 465(b) is amended by adding to the end thereof the following new subparagraph:
>
> > (F) Qualified Nonprofit Organizations.--To the extent nonrecourse financing from a "qualified nonprofit organization" (as defined in section 42(h)(5)(C)) is taken into account in computing the qualified basis (as defined in section 42(c)(1)) of a low-income building pursuant to the provisions of section 42(k)(2)(A), such financing shall be treated under this section as qualified nonrecourse financing.

B(1) Reason For Change. The at-risk rules, which were extended to the activity of holding real property by the Tax Reform Act of 1986, generally preclude an investor from deducting losses which exceed his at-risk investment in the activity giving rise to the loss. These rules also limit the amount of low-income housing credits that may be claimed with respect to projects financed in whole or in part with nonrecourse debt. Unfortunately, the rules do not work in tandem with respect to seller financing that is provided by certain nonprofit organizations whose exempt purpose includes the "fostering of low income housing." Such financing is included in basis for credit purposes under section 42, but not for loss limitation purposes under section 465.

This statutory dichotomy is apparently inadvertant insofar as there is no logical support or policy justification for the distinction. The proposed amendment cures this inconsistency by harmonizing the two basis rules, thereby permitting indebtedness qualifying under the seller financing exception to be includible in basis for both loss limitation and credit purposes.

A(2) Statutory Change. To provide that holding an investment in a partnership which owns real property constitutes the holding of real property--

Subparagraph (E) of section 465(b)(6) is amended by adding at the end thereof the following new clause:

> (iii) Holding Interests in Certain Partnerships.--Holding an interest in a partnership shall constitute the activity of holding real property, provided that at least 80 percent of the gross value of the assets of such partnership consists of real property.

B(2) Reason For Change. The proposed amendment constitutes a long-overdue codification of an informal rule which is implicit in the legislative history of the Revenue Act of 1978 and which has been followed by the IRS and most practitioners.

A(3) Statutory Change. To provide that a security interest in a partnership interest will be treated as a security interest in the qualified low-income building--

Subparagraph (B) of section 42(k)(2), as amended by S. 1350 and H.R. 2636, taking into account paragraph (8) of section 42(d) as added above, is amended by adding a new sentence at the end thereof to read as follows:

> In the event of a transaction described in paragraph (8)(A), a security interest in the section 42 partnership interest shall be treated as a security interest in the building.

B(3) Reason For Change. Government financing agencies, particularly HUD, typically will not allow a junior lien to be placed on a building which is encumbered by a mortgage which the agency holds or insures. As discussed above, the technical corrections bill recognizes this fact and purports to waive the "secured by the building" requirement of section 42(k)(2)(B) in situations where the proceeds from the financing are applied to acquire or improve the building. While we endorse this amendment, we believe the at-risk rules should be broadened to include purchase money indebtedness incurred to acquire interests in partnerships owning existing low-income housing projects. The business necessities and rationale supporting this provision are discussed in I. B. above in connection with the treatment of the acquisition of partnership interests.

IV. Credit Recapture

A(1) Statutory Change. To provide more certainty as to the allocation of credit recapture among partners of large partnerships--

Clause (iv) of section 42(j)(5)(A) is amended by striking "as such partnership's taxable income for such year is allocated among such partners" and inserting in lieu thereof "as the tax credits giving rise to such increase in tax were allocated among the partners or their predecessors in interest."

B(1) Reason for Change. The proposed amendment provides for a more rational and logical method of allocating credit recapture among partners of large partnerships, i.e., in the manner in which they previously benefitted from the credits giving rise to the recapture. The current provision is inadequate for various reasons, not the least of which is the partnership may never generate taxable income. In addition, the allocation of taxable income may bear little relationship to the method of allocating depreciation deductions, which in turn governs the allocation of tax credits under the existing section 704(b) regulations.

A(2) Statutory Change. To provide recapture rules with respect to dispositions of partial interests in partnerships other than those described in section 42(j)(5)(B)--

Paragraph (5) of section 42(j) is amended by adding to the end thereof the following subparagraph:

> (D) Treatment of Other Partnerships.--In the event a partnership does not comply with clauses (i) and (ii) of subparagraph (B), the disposition by a partner of a partnership interest shall result in recapture of the credit recapture amount attributable to the interest disposed of under the principles adopted by section 47 and the regulations thereunder.

B(2) Reason For Change. The recapture rules set forth in Section 42(j) provide no guidance as to the consequences of a partial disposition of a partnership interest where the partnership is not described in section 42(j)(5)(B). There is also a question as to whether fluctuations in a partner's share of the partnership's income may result in recapture and a permanent loss of otherwise available credits. The absence of any guidance in this regard produces investor uncertainty and may discourage investment in low-income housing projects.

There is, however, already in place a mechanism whereby dispositions of partnership interests are analyzed in order to determine whether the investment credit recapture rules should apply. This mechanism is set forth in Treasury Regulations section 1.47-6, and provides generally that a partner is required to recapture investment tax credits, on a proportional basis, when the partner's interest is reduced below 66-2/3 percent of that partner's interest in the partnership as it existed on the date the property was placed in service. Section 42 should be amended to incorporate these rules (with appropriate modification for factors unique to the low-income housing credit), thereby lending definition to what is now a muddled area.

V. Waiver of 10-Year Requirement

A. Statutory Change. To provide that HUD may waive the 10-year requirement of section 42(d)(2)(B)(ii)--

> Subparagraph (A) of section 42(d)(6) is amended by inserting the phrase "or an appropriate official from the Department of Housing and Urban Development" after the phrase" (after consultation with the appropriate Federal official)", by inserting "or such official from the Department of Housing and Urban Development" before the word "determines" and by amending subparagraph (iii) thereof in its entirety to read as follows: "(iii) by reason of other circumstances of financial or physical distress which impact adversely on the supply or quality of low-income housing."

B. Reason For Change. As section 42 now reads, the Secretary of the Treasury has the sole authority (subject to a consultation requirement) to waive the 10-year requirement. In order to correct what may have been an oversight, the amendment provides that the authority for waiver of the 10-year requirement is extended to HUD, the agency most likely to be familiar with the facts and circumstances warranting the waiver. The conditions for the waiver essentially relate to situations in which the property is in financial or physical distress and any inhibition to the property's transfer could result either in a drain on the financial resources of HUD or the Federal mortgage insurance fund, or in a depletion in the stock of low-income housing. These are basically housing issues (not Treasury issues) as to which HUD is best equipped to decide.

VI. Certification Standard - 60%/60% Requirement

A. Statutory Change. To provide for a more workable administrative standard for certifying to the Secretary that applicable income test has been met--

Paragraph (1) of section 42(g) is amended in its entirety to read as follows:

> (1) In General--The term "qualified low-income housing project" means any project for residential rental property if 60 percent or more of the residential rental units in such project at the end of the taxable year are both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income. For purposes of this paragraph, any property shall not be treated as failing to be residential rental property merely because part of the building in which such property is located is used for purposes other than residential rental purposes. [Conforming changes would also be made to other provisions of section 42 affected by this amendment.]

B. Reason For Change. As Code sections 42(g)(4) and 142(d) now read, the owner of a low-income building is required to file annual certifications with the Secretary, establishing that either the 20-50 or 40-60 tests have been met. These rules apply for purposes of determining whether the building qualifies as a low-income housing project and whether any unit in the building is a low-income unit. The determinations must be made on a continuing basis, both with regard to the tenant's income and the qualifying area income (rather than only on the date the tenant initially occupies the unit).

The foregoing unit-by-unit analysis is endlessly complex and creates a labyrinth of paperwork which ultimately results in a huge divergence of time and energy away from the task at hand, namely, the refurbishment and rehabilitation of the available housing stock. Further, by requiring that the credit be tied to a specific percentage of the low-income housing units, which percentage may fluctuate downward--thus causing recapture--depending on such variables as tenant income and turnover, investors are uncertain as to the amount of credits that any particular investment will produce. In other words, investors may be unwilling to invest in a low-income housing project if minor changes in the income status of renters have the possibility of affecting the actual amount of credit allowable.

It suffices to say that the ends do not justify the means. Where a taxpayer can certify that 60 percent of a building's units satisfy the 60 percent income test, there is little likelihood that there are a significant number of units in the building held for rent to persons other than those who meet the income tests. Therefore, section 42 should provide a threshold certification requirement: If 60 percent of the building is either rented or irrevocably held out for rent to individuals meeting the 60 percent income test, all units in the low-income building should be deemed to qualify as low-income units; conversely, if the building fails to meet such threshold, no portion of the building should qualify for the credit. By applying a "bright-line" test, investors will have greater certainty as to the amount of credits they will receive, and such certainty will impact favorably on their willingness to commit investment dollars to programs which, by their very nature, are totally dependent on tax incentives. Further, rather than being ensnarled in the mounds of red tape and the ensuing bureaucracy spawned by the current certification provisions, the project operators and housing agencies can more efficiently devote their time and energy to the needs of the tenants.

VII. Limitations on High-Income Taxpayers

A(1) Statutory Change. To permit an investor to offset any alternative minimum tax liability with the allowable low-income housing credits--

(i) Paragraph (1) of section 38(c) is amended by deleting the word "The" and by adding in lieu thereof "Except as provided in paragraph (4)(E), the"; and

(ii) Paragraph (4) of section 38(c) is amended by adding at the end thereof the following new subparagraph:

(E) Special Rule for Low-Income Housing Credit.--If after the application of the credits allowed under paragraphs (1) and (2) the taxpayer's unused credits consist at least in part of the credit described in subsection (b)(5) (assuming that the credits described in subsections (b)(1) through (b)(4) are applied first), then

(i) the amount allowable under paragraph (1) shall be increased by the unused portion of such credit to the extent of the taxpayer's tentative minimum tax (as described in section 55(b)) for the taxable year, and

(ii) the amount allowable under paragraph (2) shall be increased by the unused portion of such credit to the extent of the amount described in section 55(a).

Any unused credit shall retain its separate character for purposes of the carryforward provisions set forth in section 39.

A(2) Statutory Change. To eliminate the phase-out of the $25,000 allowance applicable to the utilization of the low-income housing credit against non-passive income--

Subparagraph (B) of section 469(i)(3) is amended to read as follows:

(B) Special Rules for Low-Income Housing and Rehabilitation Credits.--

(1) Low-Income Housing Credit. --Subparagraph (A) shall not apply to the extent that the passive activity credit for a taxable year is attributable to any credit to which paragraph (6)(B)(i) applies.

(2) Rehabilitation Credit. - In the case of any portion of the passive activity credit for any taxable year which is attributable to any credit to which paragraph (6)(B)(ii) applies, subparagraph (A) shall be applied by substituting "$200,000" for "$100,000."

B. Reason For Change. The low-income housing credit is currently subject to the limitations on the use of the general business credits, including, most significantly, the restriction which precludes an investor from offsetting any alternative minimum tax liability by the allowable low-income housing credit. Due to the changes brought about by the 1986 Act--i.e., the narrowing of the tax rates between the regular and alternative minimum tax, the expansion of the category of items subject to the tax, and the phase-out of the $40,000/$30,000 exemption-- significantly more taxpayers, particularly those in the high income brackets, will become subject to the alternative minimum tax. As a result, both corporate and individual investors are uncertain as to whether they can utilize the low-income housing credits which are potentially available to them over the 10-year period. This uncertainty has contributed to the reluctance on the part of many investors to commit capital to housing projects.

In addition, for purposes of the rules limiting passive loss deductions, the credits (but not the losses) from low-income housing projects are deemed attributable to rental real estate activities in which the taxpayer actively participates. The credits may be used to offset tax on up to $25,000 of non-passive income, subject, however, to a phase-out of the allowance between $200,000 and $250,000 of adjusted gross income (ignoring passive losses).

Given the importance of providing low-income housing, there is no reason why the allowance should be phased-out for individuals earning over $200,000. It should make no difference whether the credits are used by wealthy individuals or individuals with more modest means. However, by combining the phase-out provision with the rule barring use of the credit against the AMT, Congress has, in effect, set up unintented roadblocks to the implementation of the credit program.

It is evident that the credit is the "hook" that attracts private sector capital to what would otherwise be an unprofitable investment. By precluding high-income individuals from using the credit, Congress is alienating the group which has traditionally possessed the funds and the tax motivation to invest in low-income housing projects. There is no reason to deny housing to the needy because of some arbitrary decision to limit the utilization of the credit by wealthy individuals.

The proposed amendments are modest attempts to alleviate several of these obstacles by eliminating the phase-out of the $25,000 allowance and permitting investors to offset their AMT by the low-income housing credit. The proposal would still leave intact the $25,000 limitation (which, after 1987, effectively caps the credit at $7,000 in terms of its use against taxes on non-passive income), as well as the other general business credit limitations. Moreover, the government's purse remains adequately protected against wholesale use of the credit by the rigid income targeting rules, the volume caps on credit authority, and the limitations on carryovers of unused credits which are currently contained in the Code.

VIII. Tax Shelter Provisions

A(1) Statutory Change. To assure taxpayers that losses arising from an investment in a low-income housing syndication will not be treated as hobby losses--

> Subsection (c) of section 183 is amended by adding at the end thereof the following sentence: "Investment in an entity formed primarily for the purpose of owning low-income housing in a manner that will enable such entity (or its owners) to secure a credit under section 42 shall constitute an activity engaged in for profit."

A(2) Statutory Change. To provide that low-income housing syndications will not be treated as "tax shelters" for purposes of the substantial understatement penalty--

> Clause (ii) of section 6661(b)(2)(C) is amended by adding at the end thereof the following sentence: "The term 'tax shelter' shall not include an entity formed primarily for the purpose of owning low-income housing in a manner that will enable such entity (or its owners) to secure a credit under section 42."

B. Reason for Change. Any investment in an activity qualifying for the low-income housing credit should be exempt from the purview of Code section 183 (which prohibits the deduction of losses attributable to investments not "engaged in for profit"), as well as the more rigid standards which are applied under section 6661(b)(1) to understatements attributable to "tax shelter" investments. Present practice assumes that investors in low-income housing projects are exempt from such rules, and the IRS' current ruling position is consonant with this practice, at least insofar as it applies to section 183. See Rev. Rul. 77-300, Priv. Ltr. Rul. 8531065, and G.C.M. 38117. The proposed amendment, therefore, represents a long-overdue codification of this informal rule, and would remove any lingering doubt as to the precise reach of the statutes in question.

IX. Allocation of Credit by Partnerships

A. Statutory Change. To allow for the allocation of low-income housing credits among partners of a partnership in accordance with the manner in which they contributed the capital used to acquire or improve the project--

Subsection (m) of section 42 shall be amended by adding at the end thereof the following sentence:

> It is contemplated that the Secretary will amend the regulations under section 704(b) to permit a partnership, at its election, to allocate the credit allowable under this section among its partners in any manner which reasonably approximates the manner in which the partners' respective capital contributions were used to acquire the property or fund the expenditures giving rise to the credit. In addition, the regulations should provide that the credit is to accrue ratably over the taxable year from the date the credit is initially available to the partnership, as determined under such monthly, semi-monthly or daily convention as is permitted under section 706 and the regulations thereunder.

B. Reason For Change. Section 42 provides no guidance as to whether the low-income housing credit may be specially allocated to those partners who funded the expenditures giving rise to the credit. Under the section 704(b) regulations, it appears that the credit must be allocated on a basis consistent with the allocation of the partnership's depreciation deductions. Any such requirement constitutes a major deficiency in the statutory scheme insofar as it would impede a partnership's ability to attract capital for urgently needed rehabilitation expenditures.

The proposed amendment solves this problem authorizing the Secretary to issue regulations which would permit a partnership, at its election, to allocate credits on a basis that is reasonably related to the funding of the expenditures which gave rise to the credit. Such an allocation scheme is more consonant with one of the purposes of the statute, namely to provide tax incentives solely to those investors who provide the capital needed to acquire or renovate a project.

Section 42 should also make clear that the credits are allocable on a monthly or more frequent basis (i.e., daily basis), thus entitling new partners (or existing partners making capital contributions) to an allocation of credits commensurate with the amount of their capital contributions and the dates they made such contributions.

X. Transitional Rules

A(1) Statutory Change. To provide for a transitional rule for binding contracts, entitling taxpayers to the credit for the fourth quarter of 1987 and the first quarter of 1988--

Subparagraph (B) of section 42(f)(2) is redesignated as subparagraph (C), and the following subparagraph is added after subparagraph (A):

> (B) Transitional Rule.--If--
>
> (i) the taxpayer has entered into a binding contract to purchase the low-income building as of September 30, 1987,
>
> (ii) the taxpayer and the state where the low-income building is located have entered into an agreement described in subsection (b)(2)(A)(ii)(I) [as added by S. 1350 or H.R. 2636] on or before December 31, 1987, and
>
> (iii) the conveyance of the low-income building occurs and all other requirements of federal, state and local governmental agencies relating to such conveyance have been substantially complied with by the due date of the taxpayer's 1987 income tax return (not taking into account any extension period),
>
> then, for purposes of this section, such building will be treated as having been placed in service during the period beginning on October 1, 1987 and ending on April 15, 1988 (or the date on which such building is actually placed in service, if earlier).

B(1) Reason For Change. The process of obtaining a credit under section 42 requires, in effect, approval of two agencies. First, the transfer of the building must be approved by HUD (or other appropriate agency), and, second, the taxpayer must receive an allocation of credits from the appropriate state agency. Significant delays are inherent in such a process due to the complex regulatory requirements and the fact that, for the most part, the state agencies do not yet have the machinery in place to implement the allocation program.

All of this has created investor uncertainty as to whether credits will be available in 1987 (or indeed by early to mid-1988). Such uncertainty has hampered current efforts to raise capital, and it is suggested that this problem could be alleviated, at least in part, by assuring investors that if certain strict criteria are met they will be entitled to some portion of the credit during 1987 and early 1988, notwithstanding that the project is not placed in service until April 15, 1988.

A(2) Statutory Change. To provide for nonpassive treatment of income and credits falling under the transitional relief provision contained in section 502 of the Tax Reform Act of 1986--

> Subsection (a) of section 502 of the Tax Reform Act of 1986 is amended by substituting "Any income, loss, or credit (other than a credit determined under section 42 of the Internal Revenue Code of 1986)" for the phrase "Any loss" and by substituting the phrase "income, loss, or credit" for the phrase "a loss".

B(2) Reason For Change. Section 502 of the 1986 Act provides transitional relief for investors in low-income housing projects which were placed in service prior to 1987 and which are therefore ineligible for the credit. The transitional rule allows the investors to treat their losses from such activities as nonpassive losses for a specified period of time. However, in what was an apparent oversight, the rule fails to provide similar relief for the rehabilitation credit. The proposed amendment seeks to rectify this omission.

(5067N)
(7/7/87)

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(Attachments are being retained in Committee files.)

July 10, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The undersigned organizations, which represent tenants, state and local housing agencies, non-profit organizations, developers, lenders, and equity investors, all of whom are deeply involved in low-income housing production and preservation, are pleased to submit the attached comments with respect to the low-income housing tax credit provisions contained in the Technical Corrections Act of 1987, H.R. 2636.

We commend you for including a number of provisions in the bill which will greatly improve the workability of the low-income housing tax credit. We deeply appreciate the time that you, your staff, and the staff of the Joint Committee on Taxation have taken to listen to the concerns which we have raised with respect to this new program. We know that you have a very genuine interest in assuring that the tax credit achieves its intended purpose -- to provide decent housing for those least able to afford it.

However, there are several provisions included in the bill which we believe could use some further refinement or about which we have deep concerns. In addition, there are several matters which were not addressed in the bill which we believe are necessary in order to resolve certain remaining problems with the tax credit. These matters are discussed in detail, together with a proposed solution with respect to each matter, in the attached comments. We would very much appreciate your consideration of these comments, and inclusion at the Committee's markup of amendments reflecting the proposed solutions.

Once again, thank you for responding to our concerns. We look forward to continuing to work with you and your staff as we go forward in the legislative process.

Very truly yours,

Association of Local Housing Finance Agencies

Coalition for Low and Moderate Income Housing

Council for Rural Housing and Development

Council of State Housing Agencies

Enterprise Foundation

National Association of Home Builders

National Corporation for Housing Partnerships

National Housing and Rehabilitation Association

National Housing Conference

National Leased Housing Association

National Low Income Housing Coalition

Rural Housing Services, Inc.

I. Carryover of Allocations

[Code Section 42(h)(6)(B); bill Section 102(1)(17)]

Issue: Section 42(h)(6)(B)(i) currently provides, in effect, that if a building is not completed and placed in service in the year with respect to which an allocation has been made, the allocation is lost -- both to the project and to the State. The technical corrections bill would permit carry-forwards of low-income tax credit allocations to the succeeding taxable year if the Secretary determines (1) that it was reasonable to believe that the building would be placed in service during the allocation calendar year and (2) that the delay was caused "solely" by "unforeseen conditions which were not within the control of the taxpayer." This amendment falls substantially short of what is needed to make the tax credit workable in a new construction or substantial rehabilitation context, and is considerably narrower than the rule contemplated at page 171 of the Blue Book.

The development of multifamily housing projects is uniquely vulnerable to delays resulting from material shortages, labor disputes, problems with contractors and subcontractors, weather, litigation, problems in obtaining construction or permanent financing, difficulties in obtaining bonding, zoning or other governmental approvals, etc. As a result, completion date projections for multifamily projects are highly speculative, and may easily be off by twelve months or more. Thus, it is routine to see developers which have two to three year financing commitments request extensions of those commitments because of delays. No developer can afford to risk the amount of money necessary to commence construction or rehabilitation of a housing project if any significant construction delay will result in the loss of the tax incentives for that project.

Although intended to address the question of delays, the technical amendment contemplated by Section 102(1)(17) is simply inadequate to solve the problem. It would require Treasury to determine, on a case-by-case basis, long after construction had begun, whether any delays were "unforeseen" and "not within the control of the taxpayer", and further, whether the initially anticipated completion date was "reasonable." With delays so common an occurrence in multifamily development, it is unreasonable to expect developers to risk their investments and housing credit agencies to risk the scarce allocations to their States in the hope that, if the anticipated completion date is not met, this heavy burden of proof, relying upon subjective criteria and generalized standards, can be met before the Treasury Department.

Proposed Solution: The Technical Amendments legislation should provide a safe harbor, permitting carryovers for buildings receiving allocations of low-income housing tax credits for years after 1987 where (1) at least 50 percent of total costs of a building have been expended by the end of the allocation year and (2) the project is placed in service no later than the close of the subsequent calendar year.

In addition, projects which do not meet the safe harbor timing and expenditure tests should be permitted to seek a determination that the construction delay has been caused by "reasons beyond the control of the taxpayer," which was the standard suggested by the Blue Book. This is a far more useful criterion, because it is based on an objective test, than the one proposed in section 102(1)(17) of the bill. However, contrary to the process outlined in the Technical Corrections bill as introduced, this determination should not be made by the Treasury Department, which has neither the manpower nor the experience to make detailed case-by-case reviews of construction, financing, and other delays, but rather, by the housing credit agency. Such an approach would help to strengthen the hand of the agencies in monitoring the development process, while not penalizing either the agencies or developers for delays which are genuinely beyond their control.

If carryovers are allowed only with respect to credits allocated after 1987, as provided in he bill, the budgetary impact of this safe harbor rule will be negligible while a substantial incentive will be provided for the development of new low-income projects.

II. Waiver of 10-Year Requirement for Federally-Assisted Projects

[Code Section 42(d)(6); bill Section 102(1)(7)]

Issue: Projects which have been placed in service within the preceding ten-year period are not eligible for the four percent credit with respect to acquisition costs. The Code provides an exception for certain Federally-assisted projects if a waiver is necessary to avoid an assignment of the mortgage to HUD or the Farmers Home Administration or to prevent a claim against a federal mortgage insurance fund or "by reason of other circumstances of financing distress". The bill deletes the quoted language, clearly precluding the availability of a waiver for a Federally-assigned project which is State-or locally-financed but whose mortgage is not Federally insured. Thus, this "technical correction" actually worsens the rules for the low-income housing credit and makes it unavailable as a tool for preserving nearly half of the older Federally-assisted low-income housing projects.

The preservation of the existing low-income housing stock is the most economical way of maintaining an adequate supply of housing for low-income tenants. Without additional incentives, such as the availability of the low-income housing tax credit, much of the existing low-income housing inventory will be lost either through conversions or abandonment, exacerbating housing shortgages for the very poorest Americans. Hundreds of thousands of units of Federally-assisted housing are reaching a point over the next several years at which conversions to non-low-income use will be permissible. The low-income tax credit can provide the incentive to preserve such projects for low-income tenants.

Proposed Solution: Instead of narrowing the availability of waivers,the statute should be broadened in several ways. First, waivers should be permitted for all distressed projects (including single family homes) which are either Federally-assisted, Federally-financed or Federally-insured or which have been acquired by the Federal government. This will provide broader protection for the Federal government in its mortgage insurance funds, and expand protection to all threatened Federally-assisted projects.

Second, the bill should provide that waivers will be granted automatically (i) upon the certification of HUD or FmHA that the necessary circumstances of distress exist, in the case of Federally-insured projects or projects which are Federally-assisted and not financed by a State or local housing agency, or (ii) upon the certification of the State or local housing finance agency in the case of Federally-assisted projects which are financed by such agency.

Third, the bill should retain the authorization currently in the Code to Treasury to grant waivers to Federally-assisted projects for reasons of "financial distress," and expand that authority, with respect to federally-assisted housing, to authorize waivers if, in the reasonable determination of HUD, the housing would otherwise be converted to non-low income use. Such a waiver would be helpful particularly in situations in which the housing is not distressed but is, in fact, a prime candidate for conversion to condominiums or market rate housing. The essential purpose of the waiver rule, to prevent "churning" of projects for tax advantage, can be achieved by requiring certification of financial distress or preservation as a precondition to the granting of a waiver and by restricting waivers under this authorization (but not under the exceptions treated in the preceding two paragraphs) to projects which have never received relief under Section 502 of the Tax Reform Act of 1986.

III. Clarify Rules regarding "35 - Partner" Elections

[Code Section 42(j)(5); bill Section 102(l)(22)]

Issue: The Code provides that a portion of the low-income housing tax credits taken in previous years may be recaptured if an investor disposes of his or her interest in a low-income housing project. The statute provides a special rule for partnerships consisting of 35 or more partners. Under that special rule, the partnership may elect to be treated as the "taxpayer" for purposes of recapture, as long as no more than 50% of the interests, calculated by value, are transferred within any 12-month period.

The original language of the Code [§42(j)(B)(i)] limited this special rule only to a partnership "which has 35 or more partners each of whom is a natural person or an estate . . . ." In response to concerns that a partnership that has any corporate partner would thereby not qualify, the bill would amend §42(j)(5)(B)(i) to read: "more than 1/2 the capital interests, and more than 1/2 the profit interests, in which are owned by a group of 35 more partners each of whom is a natural person or estate . . . ."

The requirement that more than 50% of the partnership be owned by natural persons does not serve any policy goal. The policy behind allowing partners in partnerships composed of more than 35 persons to transfer their interest without recapture was a recognition that, in these large partnerships, the partnership itself could insure that the property would remain as a low-income housing project. Basing qualification for this rule on an ongoing specified percentage of ownership by individuals, as opposed to corporations, would require large public partnerships, which may have thousands of partners, to calculate continuously their percentages of corporate ownership and individual ownership and would impose needless additional record-keeping burdens that would otherwise not occur.

Furthermore, another matter should be clarified. Many low-income housing investments are structured with two partnership tiers -- an "investment" and a "project" tier; this structure is well recognized and accepted by the Internal Revenue Service and is required by HUD and other governmental agencies in order to assure that each project is owned by a separate "project" tier entity. It is done in order to allow investors, who invest directly in the investment partnership, to hold an interest in several project partnerships. However, it is not clear that the investment partnership may make the 35-partner election, even if it has 35 individuals as partners, and it is not available to the project partnership which typically has only a general partner and the investment partnership as the sole limited partner.

Proposed Solution: A solution to the problem involving corporate ownership would be to require that the percentage ownership interests specified under the bill need be met only when the partnership makes the election to be treated as the taxpayer. In that manner, there would be assurance that the partnership was initially composed of individuals holding at least a 50% interest in the partnership, which information the partnership could compile without serious difficulty. It would eliminate the costly process of continuously monitoring ownership interests after investors were initially admitted to the partnership. As an alternative, the 50% ownership rule could be deleted altogether and the Code amended to specify that to be treated as the taxpayer, the partnership must be composed of "at least 35 partners who are natural persons or estates".

With respect to the availability of the election for investment partnerships in two-tier arrangements, the Code should specify that the election may be made by a partnership which holds a majority interest, directly or through another entity, in a qualified low-income housing project.

Once again, there is no revenue impact with this provision.

IV. Deep Rent Skewing

[Code Sections 42(g)(4) and 142(d)(4); bill Section 102(1)(14)]

Issue: Special provisions of the low-income housing tax credit have been enacted to facilitate the development of projects targeted to very low income tenants (at or below 40 percent of area median income). To qualify, at least 15 percent of the low-income units must be rented to such tenants and gross rents on the market rate units must be at least three times gross rents on the low-income units (the "three to one ratio"). The chief advantages of these special "deep rent skewing" provisions are that tenant income may rise as much as 70 percent (instead of 40 percent) above the applicable income ceiling before the tenant ceases to qualify as a low-income tenant, and once a qualified tenant's income exceeds the applicable limit, only the next available low-income unit must be rented to a new very low income tenant.

The bill clarifies that for the purpose of determining whether a project complies with the gross rent limitation applicable to deep rent skewed units under the low-income housing tax credit, Section 8 housing assistance payments and similar rental assistance payments are not counted. This is consistent with the treatment of Section 8 payments generally under the credit. (See section 42(g)(2)(i).) However, the bill specifically requires that for purposes of determining whether the three to one ratio is being satisfied, such rental assistance payments are counted.

The latter provision effectively makes the deep rent skewing option unavailable in tax credit projects generally, and completely frustrates the objective of the amendment. Deep rent skewing is only a practical option in areas with relatively high construction costs and rents. In such areas, however, units can be made available to the very low income target group only if additional subsidies, such as Section 8, are provided. The deep rent skewing option is sound public policy under those circumstances because it permits developers to build economically integrated projects where rents and the benefits of the tax credit are insufficient to support the construction and operation of very low income units without subsidies. It accomplishes this by allowing a project to avoid the drastic drop in income which would otherwise occur when a tenant in a subsidized Section 8 unit goes over income, requiring that the next available unit -- an unsubsidized unit -- be given to a low income tenant at the restricted rent level.

Congress' intent with respect to the three to one ratio and deep rent skewing is clearly expressed at page II-93 of the Conference Report on H.R. 3838, which says of the requirement: "the average rent charged to tenants in the residential rent units which are not low-income units is at least 300% of the average rent charged to low-income tenants for comparable units." (Emphasis supplied.) The proposed technical amendment, which focuses not on the rent charged to the tenant but rather the total of the tenant payment plus any subsidy payment for the unit, is explicitly contrary to this expression of intent and effectively vitiates the entire deep rent skewing provision. In addition, Congress' clear intent to facilitate the construction of housing for very low income tenants will be frustrated by disallowing the use of the very rental assistance which would make such targeting possible.

There are no revenue consequences to excluding rental assistance payments from tenant rents for purposes of determining whether a credit project meets the deep rent skewed definition.

Proposed Solution: The bill should be amended so as to make the treatment of Section 8 and similar rental assistance payment consistent in the deep rent skewing provisions. Such payments should be disregarded for purposes of determining whether the three to one ratio is satisfied.

V. Infeasibility in Low Income Areas

[Code Section 42(g); not addressed in bill]

Issue: In many low income rural areas, and in some urban areas, median income levels are so low that owners of housing projects attempting to utilize the low-income housing tax credit are finding such projects to be economically infeasible. This problem is caused by the requirement in Section 42(g) that ties a project's rents to the area median gross income. Even many projects assisted under the Farmers Home Administration Section 515 program, which subsidizes mortgage interest rates for rural projects to as low as one percent, are not workable because of severely low income levels. A random sample survey conducted by the Council for Rural Housing and Development of 12 geographically diverse states has shown that in those states the rent calculated under the credit program for rural projects was well below that needed for project operation and debt service. Thus, in anywhere from 18% to 95% of the counties in those states, the credit could not be used at all, even with the mortgage subsidy provided by FmHA. Although the survey did not cover other states, it is reasonable to assume that other states are experiencing the same problem and less formal feedback from other states does confirm that the problem is a widespread one in rural areas across the country, and a problem even in some low income urban areas.

A chart showing the results is attached.

Because many low income areas cannot support necessary rent levels, housing is not likely to be built in the areas where the need is most desperate -- the poorest areas of the country.

Proposed Solution: The simplest and fairest resolution of this issue, which would solve the problem in most parts of the country, is to allow the use of the higher of the statewide or the area median gross income in establishing income qualifications. Thus, in states which have statewide median incomes sufficient to provide necessary rent levels, particularly poor counties will not be left out of the program. This proposal has a precedent in the Internal Revenue Code: under the mortgage revenue bond program, income eligibility is determined in this manner [Code §143(f)(4)].

TAX CREDIT WORKABILITY

(RANDOM SAMPLE SURVEY -- INFORMATION
ON OTHER STATES NOT READILY AVAILABLE)

STATE	Total # Counties	Unworkable Counties	Marginal Counties	Workable Counties
Arkansas	75	68	0	7
Georgia	107	68	15	24
Iowa	99	43	6	50
Kansas	101	54	21	26
Maine	20	19	1	0
Minnesota	87	44	--	--
Mississippi	79	24	2	3
Missouri	114	46	41	13
South Carolina	42	22	7	13
Tennessee	75	65	8	2
Texas	233	139	57	37
Virginia*	88	16	8	46

*17 Counties ineligible.

VI. Eligible Basis - Placed in Service

[Code Section 42(d)(5)(A); not addressed in bill]

Issue: Under Section 42(d)(5)(A), the eligible basis of any building for the entire 15 year compliance is determined on the date such building is placed in service.

A serious problem is created by this rule in that certain expenditures may be incurred by an owner of a newly constructed building after a project is opened for occupancy. For example, an owner may have opened certain units for occupancy on lower floors while continuing painting and carpeting on upper floors, or an owner may not have finished landscaping and parking areas when a project is being initially rented. If the eligible basis is fixed on the day the first unit is opened for occupancy, or even the date on which just a portion of a building is placed in service, the owner will lose a considerable amount of legitimate project costs from eligible basis.

Proposed Solution: The bill should specify that the eligible basis of a building is determined at the time that the building's qualified basis is determined. Under Code §42(f)(1), qualified basis is determined initially on the last day of the taxable year in which the building is placed in service, or if the taxpayer elects, on the last day of the succeeding taxable year. Tying the two determinations together makes logical sense and provides the owner with adequate time to complete the building. This rule would not change in any way the expenditures which can be taken into eligible basis; it would only alter the time such a determination is made. Because each state's allocation of credit authority is capped, there is no revenue loss associated with this provision.

VII. Acquisitions of Interests in Existing Buildings

[Code Section 42(d)(2) and 42(i)(5); not addressed in bill]

Issue: The Code specifies that in order to utilize the low-income housing tax credit with existing housing, the "building" must be acquired. An "existing building" is defined as one which is not "new." A problem is created in that prospective purchasers may wish to purchase all or virtually all of the partnership interests of a partnership owning an otherwise qualified building instead of buying the building itself. The parties may decide, for example, that the new purchasers will inherit certain liabilities or other assets associated with the partnership and their transaction will reflect these other matters. However, they might be precluded from structuring the transaction in this manner if they were required to acquire only the building itself.

If more than 50% of the partnership interests were transferred in any twelve month period, the partnership would be terminated for federal income tax purposes. Allowing a purchase of partnership interests instead of the real estate itself and further requiring that the resulting transaction be treated as a termination, would be a "placement in service" by the newly constituted partnership and thus could not be used to evade the ten-year last placed in service rule on existing properties under Section 42(d)(2)(B)(ii). Further, the Code specifies that the property may not be acquired from a related person, i.e., one who holds more than 10 percent of the partnership interests after the acquisition. Thus, a rule could be devised to assure that there would be no way to utilize this provision to avoid any other provisions in Section 42 or elsewhere in the Code.

Proposed Solution: Section 42(d)(2)(B)(i) should be amended by specifying that either a "building" or "not less than 90 percent of the interests of the partnership owning the building" could be acquired in order to meet the requirements of Section 42(d)(2)(A). By specifying a 90 percent threshold, there would be consistency with the related party provision prohibiting any existing partner from maintaining more than a 10 percent interest after the acquisition, and there would clearly be a tax termination and a new placement in service.

VIII. Impact of Investment Tax Credit At-Risk Provisions on Low-Income Housing Tax Credit

[Code Sections 42(k)(1) and 46(c)(8)(D)(ii)(I); not addressed in bill]

Issue: Section 42(k) of the Internal Revenue Code requires that rules similar to the rules in Section 46(c)(8) of the Code shall apply, in determining the qualified basis of a building for the purposes of the low-income housing tax credit, in the same manner as those rules apply in determining the credit base of property eligible for the investment tax credit. Under Section 46(c)(8), the amount of the credit that can be taken is significantly reduced under certain circumstances where the property has been financed with nonrecourse financing. In effect, the base, against which the amount of the credit is calculated, is reduced by the amount of the "nonqualified nonrecourse financing" outstanding with respect to the property at the end of the taxable year.

In applying this at-risk rule to the low-income housing credit, Congress wisely eliminated two requirements from Section 46(c)(8) -- that nonrecourse financing could not exceed 80% and that a commercial lender could not be related to the taxpayer. Furthermore, with respect to certain financing provided by certain nonprofit organizations, it eliminated the requirement that the lender be a commercial lender and that the property not have been acquired from the nonprofit lender. These exceptions recognized the fact that nonrecourse financing in excess of 80% is very common in connection with the development of low-income housing and that the imposition of such a requirement would have, in most instances, negated the usability of the low-income housing credit. The exceptions further recognized the unique circumstances surrounding the participation of nonprofit organizations in the acquisition or development of low-income rental housing.

While these exceptions will enable the low-income housing credit to be fully usable in some situations in which its usability would have been crippled by the unfettered application of Section 46(c)(8), there is another provision of Section 46(c)(8) which will severely hamper the availability of the credit for many other projects developed by profit-motivated persons and also for some projects being developed by nonprofit organizations. This is the provision which is contained in Section 46(c)(8)(D)(ii)(I) which would make nonrecourse financing "nonqualified", and thus reduce the credit base, if the property was acquired from a related person. We believe this was an unintentional consequence in the drafting of the bill.

It is not uncommon for the owner of a project, or one of its owners, to have also been the builder who erected or rehabilitated the project or in some other fashion to have provided some component of the property. If the person also owned more than a 10% interest in the property, either directly or through a partnership or closely held corporation, and the property was financed with nonrecourse financing in any amount, the at-risk provisions of Section 46(c)(8) would apply and make that nonrecourse financing "nonqualified". This result would take place even if the financing were from an unrelated third-party lender. Similarly, if the property is acquired from a nonprofit organization by a partnership in which that nonprofit organization retains a more than 10% interest (a circumstance otherwise contemplated and sanctioned by Section 42), the at-risk provisions of Section 46(c)(8) will apply if there exists nonrecourse financing to any extent.

Proposed Solution: The solution is a simple one. The bill should amend Code Section 42(k)(1) by eliminating the requirement in Section 46(c)(8)(D)(ii)(I) that the property be acquired from an unrelated person for purposes of determining the credit base for the low-income housing credit.

June 11, 1987

Congressman H. James Saxton
Congress of the United States
509 Cannon Building
Washington, DC 20515

Dear Jim:

Now that some of the smoke has cleared away from the Tax Reform Act of 1986, I would like to discuss with you an unfairness that needs immediate correction.

My main concern is the fundamental injustice and inequity of the "Low-Income Housing Transition Rule," adopted as part of the Tax Reform Act of 1986. This Rule provides that an investor in low-income housing, who had paid in less than 50% of his required contribution at December 31, 1986 is completely exempt from the Act's provisions limiting passive activity losses. This is a completely inequitable and arbitrary rule.

Congress originally enacted its so-called tax incentives to stimulate investment in low-income housing. I responded by making a substantial investment in a limited partnership which has invested in qualified low-income housing. At December 31, 1986, I had paid in 53.4% of my required investment. Thus, by the slim margin of 3.4%, I am completely excluded from the Rule.

I view this as a profound injustice. Congress is saying to me that because I responded promptly to the public policy of stimulating investment in this type of housing, as embodied in legislation passed by the Congress and enacted into law, I am penalized. On the other hand, had I been slow to respond to Congress' "appeal" as contained in prior tax law, I would be the beneficiary of this Rule. To me, it is completely inequitable that our Congress "changed the rules in mid-stream." If we cannot rely on the integrity of the laws passed by Congress, on what can we rely?

Another aspect of this problem is that the value of these types of properties (which were designed by Congress to only have tax advantages) will plummet because the resale potential has drastically been reduced. In the past, the sale of low income property would generate cash for much needed maintenance repairs (HUD always likes to see these projects cash starved). No doubt, over the years, there will be an increase of foreclosures and a shrinking of our housing stock for low income people.

I would appreciate your considering my views on this matter and working to introduce and/or support a Technical Amendment to the Tax Reform Act of 1986 to correct this unfair and arbitrary Rule.

Thank you.

Very truly yours,

GOODWIN ENTERPRISES

Dick

Richard C. Goodwin

GOODWIN ENTERPRISES
REPLY TO THE OFFICE OF THE UNDERSIGNED
ELLIPSE SHOPPING CENTER
RT. 73 & CHURCH ROAD
MT. LAUREL, NEW JERSEY 08054

609/235 3111

PATERSON DIOCESAN CENTER
777 VALLEY ROAD
CLIFTON, NEW JERSEY 07013
777 - 8818

July 16, 1987

To the House Ways & Means Committee
of the U.S. Congress
Room 2458
Rayburn Building
Washington, D.C. 20515

Attention: Congressman Frank Guarini

Re: Technical Changes in the Investment Tax Credit Section of the 1986 Tax Reform Act

Letter is in two sections--

1. Background on reason for the suggested change.
2. Exact nature of the change that is requested.

1. Background

Jackson/Slater, Incorporated of Paterson, New Jersey is a Roman Catholic Diocesan sponsored non-profit Housing Agency which operates the Martin De Porres Family Housing Complex in Paterson, New Jersey. Jackson/Slater, in 1980, as the complex was about to open, became the General Partner in a Limited Partnership agreement (the Housing was a Section 8 Complex) which has resulted in the availability of some $1,700,000 in funds that are now ready to be used for further assistance to the City of Paterson for family housing for low to moderate income families.

The corporation wishes to link this money with Investment tax credits that are available through the Tax Reform Act of 1986. We have held many conversations with a major securities firm on our concept and which could market the units when they are available and the expectation is that we can leverage the money from the Jackson/Slater Corporation by a factor of ten. As you can see, the Investment Tax Credits are the key. The funds in possession of the Jackson/Slater Corporation will be used as the insurance for the units and to hold the ground property which would be used for infill housing, manufactured or modular, on vacant sites in Paterson, or in the rehabilitation of already existing units or selected industrial sites suitable for such artistry as family housing.

The business plan seeks to establish two-family units, in which the ground floor tenant would enter a rental/sale agreement which would be available to him/her for the defined number of years needed to provide theInvestment Tax credits to the Limited Partnership. The market is low and moderate income families.

What will the PLAN provide?

1. Tenancy without a stake in the home and neighborhood leads generally to long-term disaster. Tenancy with the right to buy at the cost of the unit would provide the stake and roots needed to lift a neighborhood and give it new life and a new future.

2. Investment Tax Credits make possible, along with grants, gifts, and subsidized borrowing, the conditions that will permit this move which is a mix of private and non-profit monies to set up a novel and unique way of producing terribly needed family housing at affordable cost.

To summarize quickly—Jackson/Slater and its partners will purchase properties with monies received from a public offering of units. This funding, along with other assistance, will provide the money necessary to put a modular home on a vacant lot, to improve or rehab a sub-standard unit, or to purchase and improve a specific industrial site for the purpose of family housing. Jackson/Slater and Partners will retain the ground and lease it to the specific housing unit. Each family unit (the tenant on the 1st floor, and the renter on the 2nd floor) will pay rent for the Home, and, depending on the contract, will have the right to purchase the building. E.G., 1st floor tenant could have right to purchase whole building--or, a 2nd floor tenant could purchase his/her unit as a condominium. If both wish to purchase, the condominium arrangement would again apply. The family rents will include modest payments to be applied to the purchase price which is set at what was its costs when the contract was entered into for occupancy.

This right to purchase or the actual purchase will not jeopardize the Investment Tax Credit, it is hoped. Also, the occupying families would receive a negotiable option to purchase upon the occupancy of their individual units. Obvious, too, because of the economics of housing, it could happen, as the program moves on, that an original or new owner would not be qualified by income standards to meet the test of the law, and thus, the flexibility of Jackson/Slater and its participating partners would be severely limited.

The technical change that we suggest --

We recommend that the Technical Change Act establish an exception to the Revocation of the Investment Tax Credits in those cases where a tenant becomes an owner, whether he remains qualified or not, and is on land purchased and owned by Jackson Slater, and grownd leased to the Limited Partnership in which Jackson/Slater is the General Partner.

The intent is to continue to use the I.T.C. and apply them to different properties purchased according to the Business plan.

Summary --

It cannot be overemphasized that I.T.C.'s are the key to this effort. The credits provide an entry of private money into the affordable Housing efforts for low and middle income families. Flexibility is needed so that Jackson Slater with its available funds can continue to operate with the security of knowing that the I.T.C. will not be jeopardize by the achievement of its goal - affordable Housing for low and moderate Income Families who will hopefully move up the income bracket and possibily out of the limits of the I.T.C. requirements.

Also, to be remembered, is the tax benefits that will occur by the economeis of a family buying its own home and thus having a vehicle that will provide more tax revenue.

I write this request at the instructions of the Board of Directors of Jackson Slater Corporation. I am the Secretary of the Corporation. Thank you.

Sincerely,

Fr. Norman O'Connor

Fr. Norman J. O'Connor
Secretary

LOW-INCOME HOUSING CREDIT
Technical Correction
[Act § 252; Code § 42(d)]

Background

The Tax Reform Act of 1986 ("Act") provides a new credit to be claimed by owners of residential rental property used for low-income housing, in order to encourage developers to provide additional low-income rental housing and to prevent deterioration of old low-income housing. A 70 percent present value credit is provided for new buildings and a 30 percent present value credit is provided for existing buildings. A building is a new building if the original use of the building begins with the taxpayer applying to receive the low-income housing credit. In the case of existing buildings, no low-income housing credit is available unless (i) the building was acquired by purchase and (ii) at least 10 years has elapsed between the date the building was last placed in service (or the date of the most recent substantial improvement) and the date of acquisition by the taxpayer. (The technical corrections bill presently provides that placement in service by a governmental unit or in certain instances where the property was acquired through foreclosure can be ignored in making this determination).

Under the Act, each state's housing credit ceiling is to be allocated to owners of qualifying low-income housing projects by the housing credit agency of the state (although housing agencies of local governmental units within the state may be entitled to allocate a portion of the credit). The Texas Housing Agency ("THA") is such a state housing agency and is entitled to allocate the credit among owners of low-income housing within the state of Texas.

THA has acquired a substantial number of single-family homes by foreclosure upon the default of mortgage loans THA made through the mortgage revenue bond program. A condition of THA's mortgage loans was that the homes could only be used for owner-occupied residential housing. At present THA still owns most of these homes, which are largely unoccupied.

THA is considering marketing the single-family homes it has acquired through the mortgage revenue bond program to developers. As an incentive to developers to purchase the homes, THA would like to sell them with the condition that they be rented to qualifying low-income tenants and allocate low-income housing credits to those homes. All of the homes that THA would like to sell were acquired by the purchasers to whom THA made mortgage loans within the last ten years. Some of the homes were new at the time the purchasers acquired them, while others were purchased on the resale market. Therefore some, but not all, of the houses are more than ten years old.

If the purchase of the homes and occupancy of homes by THA's borrowers causes the homes to be treated as having been placed in service and the homes cannot otherwise qualify as new buildings, then the homes will be ineligible for the low-income housing credit, because all the homes were purchased by THA's borrowers within the last ten years.

Proposed Technical Correction

(1) Clarify that single-family homes (whether or not more than ten years old) will not be treated as ever having been placed in service for purposes of qualifying for the low-income credit in cases where such homes are acquired by a governmental unit from the owner-occupant as a result of the owner-occupant's default on a mortgage loan.

(2) Provide that such single-family housing which has always been owner-occupied, and therefore has never been placed in service for the purpose of producing income, will qualify for the credit available to owners of new buildings, because the original use of the building as low-income rental housing begins with the taxpayer seeking the low-income housing credit.

Rationale

The primary purpose of providing a low-income housing credit is to increase the availability of low-income housing by providing incentives to developers to build such housing. However, unless the placed-in-service requirement excludes the purchase of buildings solely for use as owner-occupied housing, a substantial opportunity to increase the availability of housing for low-income individuals will be lost.

It also follows that such homes should be treated as new buildings for purposes of the low-income housing credit if, under this rule, they are treated as never having been placed in service. Treatment as a new building will maximize the intended incentive to developers to provide more low-income housing than is presently available. Making the credit available in the case of housing that has never been used for the production of income would not permit any taxpayers who obtained tax benefits from the incentives available under prior law to take advantage of the credit unless they met present-law requirements.

Supplemental Information

This statement is submitted by Charles L. Almond, Michael A. Jungman and Debra J. Duncan of VINSON & ELKINS, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of the TEXAS HOUSING AGENCY.

July 17, 1987

MEMORANDUM

July 17, 1987

TO: Committee on Ways and Means, House of Representatives

FROM: Winn Development Company
Boston, Massachusetts and Washington D.C.

cc: Representative Walter E. Fauntroy

COMMENTS REGARDING TECHNICAL CORRECTIONS BILL OF 1987 (H.R.2636)

LOW-INCOME RENTAL HOUSING CREDIT IMPACT ON DISTRICT OF COLUMBIA

Because of its unique demographic and geographic characteristics, the District of Columbia does not receive the Congressionally intended benefits of the low-income rental credit and corrective provisions must be included in the Technical Corrections Act.

The low-income rental housing credit provided by Section 252 of the Tax Reform Act of 1986 was intended to provide specifically targeted tax benefits for the production and maintenance of low-income rental housing stocks. The amount of the credit which is allowable to each state and the District of Columbia in any particular year is limited by two factors which are defined by the population of the jurisdiction: (1) the cap on tax-exempt obligations and (2) the low-income credit cap provided by section 42 of the Internal Revenue Code of 1986 with respect to projects which are not financed by tax-exempt obligations.

Since the limitations referred to above are based on the entire population of a particular state without regard to income characteristics, the number of actual low-income citizens within a particular state is irrelevant. In the case of all of the states which have diversified populations, this permits the construction and aiding of units which will benefit a far greater percentage of its low-income citizens than if the credit was based solely on the number of low-income individuals.

While this manner of determining the amount of allowable credits benefits the states, it has an adverse impact on the District of Columbia. Since it is an urban area without the diversity of population and income found in the various states, the percentage of low-income citizens in the District of Columbia in relation to its population is high. As such, a far lesser percentage of the low-income population of the District of Columbia will be benefited by the credit.

This fact may be illustrated by comparing the District of Columbia to other urban areas with relatively high populations of low-income citizens such as New York City, Chicago, Cleveland or Boston. The credit available to benefit the low-income populations of those cities is based on the entire population of their states. Even though the District of Columbia has a similar relationship to the surrounding areas of Virginia and Maryland, however, the amount of its credit is based solely on its own population.

The impact to the District of Columbia is far from theoretical. Based on a July 1, 1985 population estimate of 626,000, and based on a hypothetical rehabilitation project with a unit cost of $38,500 and a federal grant of $5,000 per unit, the number of housing units within the District which could be aided by a $2,155 tax credit per unit (perhaps the minimum which would provide any meaningful support to a project) would be limited to 363 units per year. This number of units can only be viewed as token and would not provide any meaningful relief to the population.

The Technical Corrections Bill must recognize the unique status of the District of Columbia as our nation's capital and its unique demographic and geographical characteristics by providing additional low-income rental housing credits for it under section 42 of the Internal Revenue Code.

Title III, Section 301

1130 W. Elm Ave.
Fullerton, Ca. 92633
Aug. 3/87

Congressman Dan Rostenkowski
Chairman - House Ways and Means Committee
House Office Bldg.
Washington, D.C. 20515

Dear Congressman;

Would you be of assistance by making a fair and reasonable change in the 1986 Tax Reform Act ?

I am retired with a taxable income of about $6000.00 annually - placing me in the low tax bracket - and now, without your help - about to be penalized unfairly.

As you and your committee redress some of the unforseen inequities in the new law would you please give priority to the unfair - retroactive treatment of Capital gains.

This change imposes a steep new tax on many of us with very limited income, who invested in a small way, (in my case - a single rental house) under the old 40% Capital gain ruling, trusting that our government leaders would honor the agreement and not change the rules on existing transaction. Which is usual.

I sincerely hope that this was an oversight and that you and other members of the House and Senate to whom I and others contact will redress this unjust action by exempting transactions made years prior to the 1986 law - or by at least allowing a phase in or transition period for the existing transactions.

I think you will agree it is only fair that an agreement be honored. Let me give you my reasons for concern.

About 24 years ago my wife and I invested in a rental house with the hope that it would appreciate in value and that in our retirement we could sell it and be more comfortable financially. Our gain being taxed on the 40% basis.

Now after the usual work, years of negative cash flow- repairs, upkeep and worry common to rental property- the house is paid for and the busy street on which it is located is becoming commercial. We are receiving enquiries and hope to sell it soon and at a good profit - thus rewarding us for our incentive and years of labor. I'm sure your will agree that we should not now be penalized for our efforts, by having to pay new and unexpected taxes.

After reading the following figures you will understand why we ask you to grandfather our existing transaction and others similar.

Assuming we can sell the property somewhere between the following figures, you can readily see that the New Tax Law as it now stands and if I understand it correctly - turns a fair tax into an extremely unfair tax. One that would penalize us with a rate change from 11% up to 28% - an obscene 133% increase. All this because we did not find a buyer before the rules were changed in the middle of the game. We did try !

SELLING PRICE	OLD TAX approx.	NEW TAX approx.	"INCREASE" approx.
$100,000.00	$9000.00	$23000.00	$14,000.00
160,000.00	17,000.00	38,000.00	21,000.00

Also, starting in 1988 our minimum tax rate will be increased 4% from 11 to 15%.

The total result being a double increase for the low income individuals. Not the intent of the Tax reform I feel sure.

Bringing things into focus we find that the wealthy taxpayer - while getting a smaller increase in capital gains tax from 20 to 28% - only 8 points or 40% - were more than compensated by receiving a big 17 point marginal tax decrease-which will in most cases result in a net decrease,in taxes paid.

I have no argument with the wealthy receiving the big cut from 50% down to 33% as the 50% was too high and stifled much incentive. But I must say in fairness that the low income group are not being treated with the same respect and consideration. This I urge you to correct.

Most people I talk to and most publications I read point out these inequities in the Reform Law as it now stands. Here are a couple of examples.

1987 Commerce Clearing House . Page 544 Para.87
points out - for moderate to low income
individuals there is a 133% increase from
the 1986 - 12% rate.

Price Waterhouse- " Guide to the New Tax Law."
RICH IS BETTER. Points out that the new law is
much greater than 8 points (capital gains increase)
for those presently paying far from the 50% rate.
For those in the lower marginal rate it means a
17 point increase..

Frankly it is difficult for me to believe that you and the other architects of the 1986 Reform Law purposely planned to hit us with a 133% tax increase while giving the rich a net tax decrease.

Rather I would like to believe that this was an oversight and that you were not fully aware of the huge and unrealistic tax increase you would be placing on people in the low income group - especially those who have made a - once in a lifetime-hard earned investment.

Therefore - having brought this costly concern to your attention I am asking you to redress this real inequity (retroactive treatment of capital gains) with the same zeal, style and leadership which you displayed as you spearheaded the original 1986 reform.

Thanking you in advance for your help and interest. Believe me when I say - this is a crucial issue. To someone in my financial position we are talking about a lot of money.

Please let me hear from you soon - this will help me in deciding what to do and how to plan for 1987 and 1988 taxes.

Wishing you the best of health,

sincerely,

Albert Nash

Albert Nash

P.S. When replying please clarify another point for me.
How high will capital gains taxes be in 1988 and on ?

CCH Fed. Tax Guid 10/86 page 504 "Will never be over 28%
Fed. Tax Man. Page 4504 -1987. Capital Gains not more
than 28% even though Maximum tax 38.5%
Page 522-523 NO differential - Maximum 28%

Others like Sylvia Porter say Capital Gains could be
33% with the surtax..
Please advise who is correct...

Section 321

DAVIS POLK & WARDWELL

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212-530-4000
TELEX: ITT 421341
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4, PLACE DE LA CONCORDE
75008 PARIS

1 FREDERICK'S PLACE
LONDON EC2R 8AB

GEORGE R. INCE, JR.
212-530-4218

August 6, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill of 1987;
ISO/AMT

Dear Mr. Leonard:

The recently proposed Technical Corrections Act contains an amendment to Code Section 57(a)(3)(A) which results in the ISO tax preference item not being removed if there is a disqualifying disposition of the ISO shares. This amendment is consistent with the Blue Book discussion on page 446.

I understand that the intent of the resulting statutory scheme is that an optionee have a preference item in the year of exercise in all cases but if there is a disqualifying disposition the optionee's taxable income for AMT purposes for the year of the disposition not include the ordinary income normally triggered by the disqualifying disposition. While I believe this intent is the right result (the same amount should not be included in AMTI twice) I have difficulty finding proper authority in the Code for the result. I understand the basis adjustment rules of Section 57(a)(3)(B) is the purported authority for the result but since the basis adjustment is to be used "in determining the amount of gain or loss" I would have thought that, if the item of tax preference is going to exist in all cases, a better wording would have been:

57(a)(3) ...

B) ADJUSTMENTS

(i) [same as existing wording]

(ii) In determining the amount of ordinary income recognized for purposes of this part on any disposition of a share of stock acquired pursuant to the exercise (in a taxable year beginning after December 31, 1986) of an incentive stock option prior to the satisfaction of the holding period requirements of section 422 A(a)(1), the amount paid for the share shall be increased by the amount of the excess referred to in subparagraph (A).

However, a better solution is available. Assuming there is agreement that the spread at exercise not be counted twice under AMT rules, I believe the problem is basically an administrative concern with respect to the issues arising from possible adjustments to a prior year's tax return if the preference no longer exists because of a disqualifying disposition. My suggested solution is to utilize the existing regular tax rules for disqualifying dispositions here also. By this I mean the item of tax preference for an ISO should arise in the taxable year in which the holding period rules of Section 422A(a)(1) are satisfied, but the amount of the preference will still be calculated in the present manner i.e., relate it back to the excess of value over option price on date of exercise. This would mean that an ISO optionee would either have a disqualifying disposition with any resulting ordinary income in the year of disposition or if no disqualifying disposition occurs there will be an item of tax preference for the taxable year in which it can finally be determined there will be no disqualifying disposition because the holding period rules have been satisfied. In neither event will any tax treatment on a prior return have to be adjusted.

Very truly yours,

George R. Ince, Jr.

Title IV: Section 421

Congress of the United States
Washington, D.C. 20515

July 17, 1987

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth Building
Washington, D.C. 20515

Dear Mr. Chairman:

In response to your request for comments on the Technical Corrections Act of 1987, H.R. 2636, we are writing to request a technical amendment related to language extending the Energy Tax Credit (ETC) for several renewable energy technologies in the Tax Reform Act of 1986. The ETC, which Congress established in 1979, provided incentives to encourage the development of small scale hydroelectric projects and a variety of other renewable energy technologies.

In the case of hydro, to receive the ETC, companies were required to file their project applications with the Federal Energy Regulatory Commission (FERC) before December 31, 1985 and have their project placed-in-service by December 31, 1988. Unfortunately, many hydro projects that met the December 31, 1985 filing deadline and which could meet the various regulatory requirements will fail to meet the 1988 placed-in-service deadline because of bureaucratic delays.

As this problem was not addressed in last year's changes to the ETC, we would like to propose an amendment to solve it. The amendment would replace the December 31, 1988 placed-in-service date with the placed-in-service date already required by FERC in project licenses under the Federal Power Act. This will not alter the number of hydroelectric projects potentially eligible for the ETC as the 1985 filing deadline will remain unchanged.

In 1979, in setting the 1988 placed-in-service date for projects qualifying in 1985, Congress did not anticipate the lengthy delays at FERC in processing hydroelectric projects. No one knew that additional regulatory and legislative requirements would be implemented in the intervening years. While these additional requirements, particularly the environmental ones, have made important improvements in the licensing process, they have substantially delayed the licensing of projects.

When Congress established deadlines in 1979, it was assumed that all projects filed before December 31, 1985, and meeting applicable requirements, could be built by December 31, 1988. It seems contrary to the original intent of the law to penalize companies that have spent years going through the regulatory process and invested hundreds of thousands on hydroelectric projects, by denying them the benefits of ETC due to bureaucratic delays beyond their control. Economic changes, such as the price of oil, reduction of tax benefits in 1986, additional regulatory requirements and the attendant processing delays have substantially reduced the number of viable hydroelectric projects. If the projects that have weathered all these adversities become ineligible for the ETC, many of them will probably not be built.

We request that an amendment be added to the Technical Corrections Act which would eliminate the unrealistic December 31, 1988 placed-in-service date and instead use the date set by FERC when they issue each license. FERC, through the licensing process, insures that developers cannot "inventory" tax benefits or licenses on stale projects. Projects which do not meet the FERC deadline lose their licenses. Surely it makes sense for the agency which controls the timing of development to also determine when a project must begin operations.

It is important to deal with this amendment this year as it will significantly affect whether or not companies will continue to invest in their small scale hydro projects. This will not change the number of projects eligible for the ETC as it was assumed when the ETC was passed that projects meeting the December 31, 1985 filing date would be able to meet the 1988 placed-in-service date. In actual fact, since the December 31, 1985 filing deadline, a substantial number of projects have been eliminated due to increased licensing requirements in the 1986 Electric Consumers Protection Act. Therefore, even fewer projects will apply for the ETC than anticipated.

There is still a strong national interest in continuing the development of alternative sources of energy, especially clean renewable domestic sources of energy such as hydropower. Our amendment will make sure that sound renewable energy policy advocated in 1978 is not destroyed due to bureaucratic delays. Therefore, we urge you to support inclusion of the attached amendment in the Technical Corrections Act of 1987.

Sincerely,

THOMAS J. DOWNEY

BRIAN J. DONNELLY

Ronnie Flippo
RONNIE G. FLIPPO

Joe Kolter
JOE KOLTER

Barbara B. Kennelly
BARBARA B. KENNELLY

Ed Markey
EDWARD J. MARKEY

Raymond J. McGrath
RAYMOND J. MCGRATH

BILL FRENZEL

ROD CHANDLER

David O'B Martin
DAVID O'B. MARTIN

Jim Moody
JIM MOODY

Frank Horton
FRANK HORTON

WELLFORD, WEGMAN & HOFF
1775 PENNSYLVANIA AVENUE, N.W.
SUITE 450
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(202) 775-0200

RICHARD A. WEGMAN PAUL S. HOFF
HARRISON WELLFORD THOMAS H. STANTON
JOHN L. SACHS JANNE G. GALLAGHER

July 17, 1987

Rob
Mr. Robert J. Leonard
Chief Counsel
House Ways & Means Committee
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Leonard:

On behalf of the National Independent Energy Producers Hydroelectric Tax Reform Committee, I am submitting a memorandum in support of a request for an amendment to the Technical Corrections legislation now being considered by the Ways & Means Committee. Also attached are proposed amendment language and a revenue estimate. This amendment would substitute for the placed-in-service date of the Energy Tax Credit for small hydros the startup date required in FERC licenses for qualifying hydro projects.

We have discussed this amendment with Janice Mays.

Sincerely,

Harrison

Harrison Wellford
Dawson Mathis

Enclosures

JUSTIFICATION FOP CHANGING THE PLACED-IN-SERVICE DATE FOR SMALL HYDRO PROJECTS WHICH QUALIFIED FOR THE ENERGY TAX CREDIT ON 12-31-85

A number of small scale hydro projects (projects less than 80 MW) which have been under development for several years may lose their right to receive the Energy Tax Credit because of an arbitrary deadline established by Congress 8 years ago. When Congress passed the Energy Tax Credit in 1979 for qualifying small hydro projects, its goal was to encourage the development of clean, renewable, domestic sources of electrical energy which would reduce our dependence on foreign oil. Because of a strong response from small power producers willing to put private capital at risk, this goal has been largely realized. More than 1,000 MWs of clean, renewable hydropower have come on-line or been approved for development by FERC since 1980.

Under the 1979 Energy Tax Act, projects which had permit or license applications pending at the Federal Energy Regulatory Commission ("FERC") on 12/31/85 would qualify for the ETC if their facilities would be placed-in-service by December 31, 1988 -- three years later. This three-year period was set by Congress 8 years ago before developers had any experience in getting projects through the regulatory maze at FERC (PURPA, which provided a market for these projects, had passed only the year before, in 1978). There is nothing in the legislative history which explains why Congress chose this length of time. The only occasion on which Congress specifically considered the length of time required to complete a hydro project -- during amendments to the Federal Power Act -- it allowed a period of four to six years for licensed projects to complete construction.

What no one anticipated in 1979 was the long bureaucratic delays at FERC in processing permit and license applications for these projects. Major legislative and regulatory changes since 1979 have greatly lengthened the approval period.

A review of license applications since 1980 shows that it usually takes between three and six years for the typical project to be licensed by FERC and several years longer for many other projects. Both Congress and FERC have changed the rules of the game during this eight-year period, adding months and sometimes years to the regulatory clearance process. In 1985, FERC promulgated pre-consultation regulations which required notification and often negotiation with more than 10 Federal and state agencies before an application could be filed with FERC. The requirement of "cumulative impact assessments" on selected river systems froze any action on projects for months at a time. Passage of the Electric Consumers Protection Act in 1986 added more regulatory hurdles for all pending projects. Extensive new rounds of consultation with environmental agencies were required, even where these agencies had already signed off on the projects.

As a result, the length of time needed for preparing a license application, the time required for FERC to act on it, and the time required for a developer to implement it have all increased substantially over the last eight years.

The cumulative effect of all these delays means that it takes far longer to bring a project on-line than originally estimated. It now appears highly likely that many worthwhile projects, despite the best efforts of their developers, will not be able to meet the December 31, 1988, deadline because of regulatory delays beyond their control. Given the current difficult financial circumstances of the small hydro industry buffeted by low energy prices, loss of the ETC may cause many projects to fail.

The arbitrary nature of the three-year "placed-in-service" deadline in the Energy Tax Act is highlighted by the fact that Congress, in passing the Federal Power Act and FERC in implementing the Act, assumed that at least four years and probably six years would elapse between the issuance of a license and bringing the licensed project on-line. Section 13 of the FPA provides for a two-year period between issuance of a license and commencement of construction and allows for a one-time two-year extension which is routinely granted by FERC; in addition, the FERC license normally gives developers two years after commencement of construction to place the facility in service. Extensions of this two-year period may be granted in special cases.

Compare this system with the three-year placed-in-service date required of projects qualifying for the ETC. Given the realities of the current regulatory process, only projects with licenses issued by 1985 had any chance of meeting the December 31, 1988, placed-in-service deadline. Even those licensed projects would have to accomplish in three years what the Federal Power Act routinely allows four to six years to complete. Projects with permit or license applications pending on 12/31/85 will have virtually no chance at all to meet this unrealistic deadline. If Congress intended that only licensed projects would receive the benefit of the ETC after December 31, 1985, it presumably would have said so.

Placed-in-service dates are designed to keep transitioned projects from having an open-ended claim on the Treasury. They are a necessary and appropriate part of prudent tax legislation. They are designed to prevent developers from "inventoring" tax benefits on stale projects. But placed-in-service dates should not be set in such an arbitrary fashion that they defeat the purpose of the underlying legislation.

In this case, the requirement of a placed-in-service date in the ETC legislation was unnecessary. FERC sets a deadline for project completion in every license issued on a small hydro project. Projects which fail to meet this deadline may have their licenses revoked. Since the FERC controls the pace of the regulatory approval process, it makes sense that FERC should have the final say about when a project should be required to begin operation.

We propose that Congress replace the December 31, 1988, deadline with the placed-in-service date established by FERC in the license issued for the project. Nothing in the legislative history indicates that Congress intended that the placed-in-service date enacted by Congress in 1979 would snuff out viable projects on the threshold of completion. As this amendment will not change the 12/31/85 filing deadline, it will not add to the number of projects eligible for the ETC.

The costs of the Energy Tax Credit were funded with monies obtained from the Windfall Profits Tax legislation of 1980. Revenue estimates were made in 1979 of the cost of all the various business energy tax credits. Congress anticipated that the hydro energy tax credits would cost $1.8 Billion over 10 years. Even assuming that all the projects issued licenses by FERC from 1980-86 were built and claimed the credit, the costs in this time period were less than 1/4 of what Congress anticipated. ($132 million versus $567 million) As clearly not all projects receiving licenses were actually built, this estimate greatly understates the difference between Congressional estimates and what was actually claimed. If the 1988 placed-in-service date were replaced with the date set by FERC in a license, an additional $38,000,000 would be claimed. Combined with the ETC claims anticipated through 1988, this means the total credits claimed over the life of the ETC would be $190 million versus the $1.8 billion planned in 1979 - approximately 1/10 of what was anticipated.

Based on the 1980 Congressional revenue estimates, we assume that Congress expected to pay for the ETC of all projects qualifying at the end of 1985. In fact, many projects which qualified for the ETC at the end of 1985 have been terminated due to increased licensing requirements in the 1986 Electric Consumers Protection Act. Therefore even fewer projects will apply for the ETC than anticipated. For these reasons, we believe our proposal is essentially revenue neutral.

In last years Tax Reform bill, Congress extended the Energy Tax Credits for commerical applications of several renewable energy technologies such as solar, geothermal and biomass. Language related to small scale hydro's energy tax credits was not considered at that time. In order that the companies developing small scale hydro can make decisions on whether or not to continue investing in these projects, it is important to deal with this problem in this years Technical Corrections bill.

As the recent data on the increasing cost of oil imports and its effect on our balance of payments indicates, it is still vital to continue to encourage the development of domestic renewable energy sources. We urge your support of this techical amendment so that small scale hydro development can realize its full potential.

Proposed Statutory Language

Section 46(a)(2)(C)(iv) of Title 26 of the Internal Revenue Code should be amended by striking "December 31, 1988" and inserting in lieu thereof: "the placed in service date required by the Federal Energy Regulatory Commission in the project license."

July 14, 1987

Summary of the Effect on Tax Revenue due to the Energy Tax Credits If Placed-In-Service Date Is Set by FERC

The data below shows the estimated revenue loss to the U.S. Treasury for various placed in service dates. These numbers were obtained using the following approach:

1. The total megawatts eligible for ETC under each of the two placed in service deadlines were multiplied by $1.2 million to determine the estimated value of the project.

2. Using the appropriate ETC tax rates* for 1987 and 1988 and assuming that the 1988 rate would be continued for any extension, the Energy Tax Credits were calculated by multiplying the rate times the value from #1.

3. Because taking the ETC will reduce the depreciable basis of a project, the actual cost of the ETC to the Treasury will be reduced due to the lower depreciation deductions. The Effect on Depreciation figures were calculated by taking the value of the ETC x each of the the five year ACPS percentages** x 34% corporate tax rate and totaling these five numbers. (The use of the 5 year ACRS rates assumes only transitioned property will be eligible for the ETC) This number shows what the depreciable value of the ETC would be.

4. The Loss to Treasury was calculated by subtracting the Effect on Depreciation values from the ETC values.

	TABLE 1 FERC Sets Placed-In-Service Date (Includes 1988 projects)	TABLE 2 Projects Placed In-Service by 1988	TABLE 3 Projects Placed In-Service Post 1988
# OF PROJECTS/MW	237 / 656MW	107 / 158MW	130 / 500MW
ETC VALUE	$53,031,000.	$15,451,000.	$37,580,000.
DEPRECIATION EFFECT	$18,030,000.	$ 5,253,000.	$12,777,000.
TOTAL REVENUE LOSS	$35,001,000.	$10,198,000.	$24,803,000.

The three tables summarizing how we determined the number of projects eligible for the Energy Tax Credits for the different placed in service dates are attached as well as the assumptions made in these calculations.

When the Energy Tax Credits were established in 1979, revenue estimates were made by Congress on the loss to the Treasury. The figures below compare the credits claimed to date and what may be claimed in the future versus what the Congress estimated would be claimed.

It should be noted that the estimate of what has been claimed from 1980 through 1986 is based on data from FERC on the number of licenses issued during this time period. This estimate is probably much higher than the actual amount claimed because not all projects issued a license are built and the number below includes municipal projects, most of which are not eligible for the ETC.

	Congressional Estimate of ETC Claims	Estimated ETC Claims from Projects Issued License
1980 - 1986	$567,000,000	$ 132,132,000
1987	$427,000,000	$ 8,930,000
1988	$582,000,000	$ 6,521,000
1989	$137,000,000	$ 12,184,000
1990	$ 84,000,000	$ 16,474,000
1990-1994	not estimated	$ 14,071,000
TOTAL	**$1,797,000,000**	**$ 190,312,000**

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* ETC Rates:
1986 - 11%
1987 - 9.075%
1988 - 7.15%

** 5 Year ACRS Rates
Year 1 - 15%
Year 2 - 22%
Year 3 - 21%
Year 4 - 21%
Year 5 - 21%

Table 7.—Estimated Budget Effect of Business Energy Tax Incentives as Agreed to by the Conference Committee, Calendar Years 1980–85

Provision	1980	1981	1982	1983	1984	1985
Business energy investment credits:						
Solar and wind property including solar process heat equipment, 15% energy credit	−10	−19	−34	−108	−282	−497
Geothermal equipment, 15% energy credit	−1	−2	−2	−5	−8	−11
Ocean thermal energy conversion equipment, 15% energy credit	([2])	([2])	([2])	([2])	−2	−2
Small-scale hydroelectric facilities, 11% energy credit	−7	−13	−17	−21	−81	−144
Cogeneration equipment, 10% energy credit	−31	−53	−78	−82	−65	−36
Petroleum coke and pitch, regular investment credit and accelerated depreciation	−25	−30	−34	−38	−43	−47
Certain equipment for producing feedstocks			([1])	−22	−29	−28
Alumina electrolytic cells, 10% energy credit	−1	−1	−1	−1	−1	−1
Coke ovens, 10% energy credit	−37	−46	−56	−59	−45	−23
Biomass equipment, 10% energy credit	([2])	−4	−4	−18	−160	−352
Intercity buses, 10% energy credit	−5	−5	−6	−6	−7	−7
Affirmative commitments, special transition rule			([1])	−448	−358	−202
Total, energy investment credits	−117	−173	−232	−808	−1,081	−1,350

Table 7.—Estimated Budget Effect of Business Energy Tax Incentives as Agreed to by the Conference Committee, Calendar Years 1986–90—Continued

Provision	1986	1987	1988	1989	1990	1980–90
Business energy investment credits:						
Solar and wind property, including solar process heat equipment, 15% energy credit	−78	−30	(1)			−1,058
Geothermal equipment, 15% energy credit	(1)					−29
Ocean thermal energy conversion equipment, 15% energy credit	−1					−5
Small-scale hydroelectric facilities, 11% energy credit	−284	−427	−582	−137	−84	−1,797
Cogeneration equipment, 10% energy credit	−11	(1)				−356
Petroleum coke and pitch, regular investment credit and accelerated depreciation	−52	−58	−63	−68	−74	−532
Certain equipment for producing feedstocks	−22	−9	(2)			−110
Alumina electrolytic cells, 10% energy credit						−12 [3]
Coke ovens, 10% energy credit	−7	−3	−1			−277
Biomass equipment, 10% energy credit	−55	−32	−23	(1)		−648
Intercity buses, 10% energy credit						−36
Affirmative commitments, special transition rule	−90	−42	−12	(1)	(2)	−1,152
Total, energy investment credits	−600	−601	−681	−205	−158	−6,012 [3]

Title V, Section 501

This statement was prepared by James R. Allen, acting in the capacity as an Enrolled Agent and specialist in international taxation.

For taxpayers who have rental properties they actively manage, up to $25,000 of rental losses can be used to offset nonpassive income (Code Sec. 469(i)). For married taxpayers filing joint returns this special allowance is phased out between $100,000 and $150,000 of modified adjusted gross income.

According to the Committee reports, a taxpayer will be considered to actively manage a rental property if (1) he owns at least a 10 percent interest in the property, (2) he participates in the making of management decisions or arranges for others to provide services in a significant and bona fide sense and (3) the property is not a net lease property.

The Congress was concerned that some married taxpayers might attempt to obtain the benefits of the special allowance that would otherwise be unavailable on a joint return by filing separate returns instead. Code Section 469(i)(5)(B) reduces the special allowance to "zero" for married taxpayers filing separate returns who did not live apart from each other during the entire tax year.

Nonresident aliens (NRAs) with U.S.-sourced rental income that is not from net leases are deemed to have income that is effectively connected with a U.S. trade or business and are taxed at the same graduated rates on the income from such rentals as U.S. citizens and residents (Code Section 864(c)(2)).

Even though an NRA does not have a substantial presence in the U.S. or is otherwise in close proximity to his U.S. real property holding(s), he would still be actively participating in the managing of the property if he arranges for a property manager to provide the necessary services such as finding tenants, collecting rents, making repairs, etc.

An NRA deemed to be actively participating (as defined above) in the management of real property should be entitled under Code Section 469(i) to deduct up to $25,000 of losses arising from such rental properties against nonpassive income.

NRAs married to other NRAs are prohibited from filing joint returns with their nonresident spouses when reporting U.S.-source income (Code Section 6013(a)(1)). Hence, they must file separate returns. Assuming the spouses do not live apart from each other during the entire tax year, it appears that Congress unintentionally denied the special $25,000 benefit to married NRAs while leaving such benefit intact for single NRAs. Such discrimination against married NRAs is probably contrary to the nondiscrimination provisions of the treaties of Friendship, Commerce and Navigation now in force between the United States and other nations.

Recommendation

I recommend the Congress include in the Technical Corrections Bill of 1987 an additional subparagraph, designated as Section 469(i)(5)(C), to read as follows:

(C) MARRIED NONRESIDENT ALIENS - Subparagraph (B) shall not apply to nonresident aliens required to file separate returns under section 6013(a)(1).

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COMMITTEE
FOR
FUTURE INVESTMENT
IN AMERICA'S PAST

July 17, 1987

Robert J. Leonard, Esq.
Chief Counsel, Committee on Ways & Means
U.S. House of Representatives
Washington, D.C. 20515

Re: Technical Corrections Act
of 1987 (H.R. 2636)

Dear Rob:

The following comments are submitted by the Committee for Future Investment in America's Past (CFIAP), a coalition of private and public sector individuals and organizations active in rehabilitation and historic preservation, for consideration by the Committee on Ways and Means with respect to H.R. 2636, the Technical Corrections Act of 1987. These comments, as described in more detail below, suggest technical corrections concerning the application of both the at-risk credit base rules to the rehabilitation tax credit and the passive activity limitations to investment in rehabilitated hotels.

1. Extension of At-Risk Credit Base Exception

A technical correction to section 46(c)(8) of the Internal Revenue Code (the "Code") should be made to conform the at-risk credit base rules provided for the low-income housing credit to those applicable to the rehabilitation credit.

Background

The Tax Reform Act of 1986 (Pub. L. No. 99-514) (the "Act") extended the at-risk credit base rules to real estate activities for the first time (section 503(a) of the Act; Code sections 465 and 46(c)(8)). Property that qualifies for the new low-income housing credit, however, is exempted from certain of the at-risk credit base rules including (1) the limitation on nonrecourse financing to 80 percent of the property's credit base, and (2) the requirement that financing be obtained from an unrelated party (although special limitations as to the lender do apply) (Code section 42(k)).

Problem

Like the low-income housing credit, the rehabilitation credit was provided by Congress to stimulate investment in projects that otherwise would not be funded. Congress recognized the significant risks and difficulties inherent in obtaining financing for low-income housing projects, and therefore provided exceptions from the new at-risk limitations for those projects. Rehabilitation projects are subject to the same types of financing obstacles as low-income housing projects. In fact, the rehabilitation credit is often used to create low-income rental housing. In certain cases, these two credits will be used in tandem (with appropriate basis adjustments as required by law.) In these cases it is particularly difficult to have to comply with two different versions of the at-risk rules for the same project.

Proposed Change

The at-risk rules for purposes of determining the rehabilitation credit base of rehabilitation property would apply in the same manner as they apply in determining the qualified basis of a building for low-income housing credit purposes.

A new subparagraph (G) should be added to section 46(c)(8) as follows:

> "(G) Special rule for certain rehabilitation property. --
>
> > (i) In general. -- Subparagraph(D) shall be applied to qualified rehabilitation property as if section 42(k) applied to such property.
> >
> > (ii) Qualified rehabilitation property.-- The term "qualified rehabilitation property" means property attributable to qualified rehabilitation expenditures determined under section 48(g)(2)."

2. Availability of Limited Exception from the Passive Loss Rules for Investment in Rehabilitated Hotels

A technical correction is necessary to correct a situation created by certain language contained in the Senate Finance Committee Report (S. Rep. No. 313, 99th Cong., 2d Sess. 743 (1986) (the "Report"); as restated in Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS-10-87, 217 and 249 (1987)) to provide clearly that tax credits arising from the rehabilitation of a hotel should qualify for the $7,000 exception to the passive loss and credit limitations.

Background

The Act contained a limited exception for rental real estate activities from the limitations on the use of losses and credits generated by "passive activities". Although all rental activity is deemed to be passive without regard to the extent of taxpayer participation (Code section 469(c)(2)), an individual taxpayer is allowed to offset nonpassive income and tax liability by up to $25,000 in losses and credit equivalents generated by rental real estate activity in which the individual "actively participates" (Code section 469(i)). Individual investors in rehabilitation tax credit rental projects can qualify for the rental real estate exception without meeting the active participation requirement.

The Report states, however, that the operation of a hotel is not a rental activity and, therefore, that a hotel is not a rental real estate undertaking (Report at 743). Thus, taxpayers investing in the rehabilitation of structures operated as hotels apparently are excluded from the $25,000 ($7,000 credit equivalent at the top bracket) exception regardless of the extent of their participation.

Problem

The Report language removes the rental activity "taint" from the operation of a hotel, protecting taxpayers involved in such activity from automatically being deemed engaged in a passive activity. *See* Report at 742. The language thus seems intended to protect taxpayers investing in hotels. The unavailability of the limited exception from the passive loss rules, however, may discourage and restrict investments in hotel rehabilitations.

It does not seem likely that Congress intended this language to limit credits for hotel rehabilitations. Indeed, since the special exception for the rehabilitation credit was not created until conference, the hotel language could not have been drafted with the intent of further limiting the rehabilitation credit exception. To deny investors in rehabilitated hotels eligibility for the exception on the grounds that the operation of a hotel is not rental activity, and therefore the rehabilitation of the hotel is not rental real estate activity, nullifies much of the utility of the exception. This could not have been what the conferees intended. Moreover, there is no policy reason to distinguish between a taxpayer who invests in the rehabilitation of a building that is leased to a hotel operator from one investing in the rehabilitation of a building leased as office space.

Proposed Change

Tax credits arising from the rehabilitation of a hotel should qualify for the $7,000 exception. This could be accomplished by adding the following language in the Committee Report accompanying H.R. 2636:

> "By not classifying hotels as rental real estate activities, Congress did not intend to deny investment in rehabilitated hotels the benefit of the limited rental real estate exception. Moreover, the exception from the passive activity limitation for the rehabilitation credit is premised on investment in a rental real estate activity. Therefore, solely for purposes of claiming the rehabilitation credit, a taxpayer may elect to treat a hotel as a rental real estate activity."

I would welcome the opportunity to answer any questions or discuss this matter with you or your staff.

Respectfully submitted,

Sally G. Oldham
Co-Chair, Committee for
Future Investment in
America's Past

FRIEDMAN
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July 15, 1987

Robert Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

We are a regional firm of Certified Public Accountants and have a substantial number of clients in the real estate industry. Our comments in this letter relate to several of our clients who we believe have been unfairly treated under the "passive loss" provisions of the Tax Reform Act of 1986 (TRA-1986). We are writing to you to gain your support for relief through technical corrections or through other appropriate alternatives.

The intent of Congress in introducing the passive loss rules (Sec. 469 IRC) was clearly stated in the Senate Finance Committee Report on H.R. 3838 (Pages 713-718). In summary, these rules were adopted to significantly limit the use of tax shelters to restore faith in the Federal income tax system, and to change the perception of average citizens that they are bearing a disproportionate burden of the costs of government because of the tax shelters of the wealthy.

The Senate intended to solve the problem by preventing outside investors from avoiding tax liability on salary and portfolio income by investing in tax shelters. In addition, they attempted to achieve fairness by allowing those active in businesses (except rentals) to which tax preferences are directed to utilize those benefits even though they may shelter unrelated income. However, with respect to several of our clients, the passive loss rules have not been successful in achieving Congress' goals because the rules prevent our clients from even being able to apply tax losses from rental activities against income derived from non-rental activities related to the real estate business. Thus, the passive loss rules single out rental real estate for harsher treatment than other businesses because those active in other businesses can apply losses realized in those businesses against all other categories of income.

The "passive loss rules" operate by not allowing the deduction for the excess of losses from passive activities over income from such activities. The term "passive activities" includes any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate. Rental activities are arbitrarily treated as passive activities whether or not the taxpayer materially participates.

Under the rules, portfolio income (which among other things includes interest income) is specifically not treated as income from a passive activity. However, interest income will not qualify as portfolio income where it is derived in the ordinary course of a trade or business and it will not qualify as passive income if the material participation standard is met.

Our clients own directly a substantial amount of rental real estate. Their activities consist of developing real estate and/or buying, holding and managing commercial and residential rental properties and selling the properties when it is appropriate to do so. They generally hold the rental properties for a substantial period of time before they sell them. When a property is sold, they have often taken back a purchase money note of the purchaser while electing the installment method to report the gain on sale. To summarize, our clients are real estate professionals engaged full-time in the real estate business (i.e., developing, buying, managing and selling), and it was not intended by Congress to have their tax benefits curtailed as a result of tax reform efforts.

As a result of the enactment of the passive loss rules, we have projected that our clients will have non-deductible passive losses arising from rental activities and, concurrently, will have to recognize development, management and portfolio income (arising from interest on the purchase money mortgages). While it is true that the passive loss limitation merely defers the losses from a passive activity until all assets involved in the activity are sold, our clients will not sell all of their rental properties to recoup the losses because this is the business from which they earn their livelihood and they are not ready to retire. The tax laws should not be designed to encourage one to abandon his occupation.

Since the real estate business has been singled out for arbitrary treatment where rental activities are present, we suggest that other activities connected with the real estate business (including interest on purchase money mortgages) should necessarily be accorded passive treatment as well. Assuming this change is made, our clients would still be unable to offset net losses from the real estate business against non real estate related income, something which professionals in other fields can do.

We are not asking for a result that is unsupported by the expressed intent of the Senate in passing this legislation. This change would give to our clients the tax benefits which relate to the trade or business that they are in. Even though the passive loss rules arbitrarily separate their business into rental and other activities, the Tax Code should not operate in such a manner so as to deny a real estate professional the opportunity to offset deductions or losses incurred in his trade or business against all sources of income included in that same business. It would be wrong for us to have to suggest to taxpayers that they have to sell all of their rental properties to use their deductions or that they sell their mortgages and invest in a vechicle which generates passive income.

We trust that the foregoing information will enable you to develop a remedy for this unfortunate and unfair situation. We deeply appreciate your interest and your assistance.

Very truly yours,

Robert Kaplan

Robert Kaplan

July 16, 1987

Statement of J&B Management Company

on

H.R. 2636

The real estate management company J&B Management Company and its affiliated partnerships (J&B)*/ own and operate 152 multifamily housing projects in 19 different states.**/ Over half of the projects participate in HUD's rent subsidy programs, such as its Section 8 program, making J&B one of the largest owners of low-income units in the country.

J&B strongly supports Section 105(a)(10) of H.R. 2636. This section reiterates that the passive activities rules in the Tax Reform Act of 1986 apply to post-1986 income recognized on pre-1987 installment sales. Without this provision, Treasury's proposal to deny passive activity treatment to such income from pre-1987 installment sales will have a profoundly adverse effect on J&B's ability to continue to provide housing to low income tenants. (IRS Announcement 87-8, December 24, 1986).

Over the years J&B has, as a regular matter, sold projects to others on an installment sales basis. Often this was the only way the new owner could afford to purchase the property. Some of the income from these past installment sales will be recognized in 1987. Under current market conditions this income from past installment sales will represent the vast bulk, perhaps 80% to 90%, of J&B's 1987 total expected income. The low-income properties currently owned by J&B are generating little or no income, and most are, in fact, generating losses which in total may equal most of the income that will be recognized this year from the prior installment sales.

If Treasury's proposal to treat income from pre-1987 installment sales differently from any other kind of passive activity prevails, J&B will be required to pay tax on the income realized from the installment sales without any recognition of the losses incurred in the same year by the same taxpayer from the same type of real estate properties. This would be an extremely illogical and inequitable result. Section 105(a)(10) avoids this result, and by treating the passive income from such prior installment sales the same way as deductions generated by J&B's existing passive investments, will make it possible for J&B to offset one against the other.

---

*/ This statement is submitted to the House Ways and Means Committee by Mr. Bernard Rodin in his capacity as general partner of J&B Management Company.

**/ The states are Texas, Missouri, Georgia, South Carolina, Louisiana, North Carolina, Oklahoma, Florida, Kansas, New Jersey, New Mexico, Pennsylvania, Arkansas, California, Illinois, Kentucky, Maryland, Michigan, and Tennessee.

Section 105(a)(10) of H.R. 2636 is fully consistent with the purpose of the underlying passive activity rules, which is to prevent a taxpayer from using losses from passive activities to shelter earned income. The proposed language preserves that policy. It is also consistent with the clear meaning of the language in last year's Act. Section 469 of the new Code provides that income from one passive activity shall be deducted against passive losses from another. These passive activity rules apply to income or losses recognized in "taxable years beginning after December 31, 1986." (Section 501(c)(1) of the Reform Act). Nothing in the 1986 Act's transition provision suggests that income so recognized in taxable years beginning in 1987 from pre-1987 installment sales might be singled out for any different treatment. To the contrary, Section 501(c)(2) of the 1986 Act specifically provides that carry-overs of pre-1987 Net Operating Losses shall not be subject to the passive activity rules, thereby indicating that in the absence of such specific exemption, income or losses realized in 1987 from pre-1987 transactions would be subject to the same rules as any other passive income.

Enactment of Section 105(a)(10) as part of H.R. 2636 will, therefore, protect the original intent of the 1986 Tax Reform Act. The provision will do no more than ensure that the substantive policies Congress adopted last year are implemented in the way intended. In the absence of such provisions, the unintended and unexpected impact of the Reform Act's passive activity rules on J&B will seriously harm this company's ability to maintain its investments in low-income housing.

Section 502

LANDMARK DEVELOPMENT, INC.

LEON E. BROCK
President

July 2nd, 1987

Robert Leonard, Esq.
Chief Counsel
House Ways and Means Committee
1102 Longworth HOB
Washington, D. C. 20515

RE: H.R. 2636

Dear Mr. Leonard:

Since my letter to you of June 23rd, 1987, our continuing inquiries have uncovered an absolutely compelling reason why proposed new subsection 502 (d) (3) will fail to carry out Congressional intent to make a substantive correction of a recognized inequity, and not merely add a cosmetic subsection.

The reason that new subsection 502 (d) (3) fails to make a substantive correction of a clear injustice is that it's too late now for this particular remedy--that is a remedy consisting only of relaxation of restrictions on the tax losses generated by the Overlooked Class (the class of projects placed in service between Jan. 1, 1986 and August 16, 1986). The syndication market has moved on from projects based on tax losses to projects based on tax credits or other benefits. We found that many syndicators will not now go back to marketing interest in tax loss projects. Some syndicators might consider it, but net proceeds to developers will probably not even be adequate to reimburse up-front costs of development and expenses of syndication. To treat the Overlooked Class equitably will require sufficient additional proceeds of syndication or other benefits to provide working capital for the next project and make the continuing development of low-cost housing an attractive business.

Of course the inequity to the Overlooked Class is exacerbated by the expenses of aborted syndication and by the reduction of losses over time. See our memo transmitted to you on June 23.

We believe Congress desires to give substantive relief to the Overlooked Class. This result requires benefits in place of, or in addition to, the current provisions of H.R. 2636. We reiterate our request for amendments specifically targeted to the Overlooked Class.

Thank you for your consideration.

Sincerely yours,

Leon E. Brock

LANDMARK DEVELOPMENT, INC.

LEON E. BROCK
President

June 23, 1987

Robert Leonard, Esq.
Chief Counsel
House Ways and Means Committee
1102 Longworth HOB
Washington D. C. 20515

RE: H.R. 2636

Dear Mr. Leonard:

The purpose of this letter is respectfully to request that special relief, in addition to, or in lieu of the elimination of restrictions on use of losses, should be targeted to the class of low-income projects placed in service between Jan. 1, 1986 and August 16, 1986.

The enclosed memo spells out the reasons why proposed new Section 502 (d) (3) offers very little, if any, relief to the developers who placed FmHA Section 515 projects in service in the above period.

We respectfully suggest that this special relief should be significant because of the very heavy disadvantage to the project placed in service August 5th, 1986 compared to a project placed in service two weeks later (after August 16, 1986). H.R. 2636 attempts to meet this problem by eliminating in 1987 an inequity created in 1986. We respectfully submit that H.R. 2636 does not go nearly far enough to do either equity or justice to developers of projects in the aggrieved class (placed in service between Jan.1,1986 and August 16,1986).

Many thanks for your consideration of this important matter.

Very truly yours,

Leon E Brock

Leon E. Brock

LEB/bd
Enc.

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PROPOSED NEW SECTION 502 (d) (3)
IN H. R. 2636
DOES NOT
PROVIDE ADEQUATE REMEDY

This memo relates to the class of subsidized projects placed in service in the period Jan 1, 1986 to August 16, 1986. A chronology of one project in the aggrieved class, Fairview is set forth in Schedule A. attached.

The relief provided to the aggrieved class under proposed new Section 502 (d) (3) must be considered from the standpoint of the developer as well as the syndicator. The proposed amendment under H.R. 2636 is of very limited benefit and falls far short of a just solution.

1. It does not take into account the heavy effort and expense needed to prepare and offering of limited partnership units. See attached Schedule A.
2. Depreciation allowances are not available to investors until after syndication (assumed to be late 1987), and the total syndication proceeds will consequently be lower because of the delay. The losses prior to the delayed syndication are and will be of very limited benefit to the General Partners. See attached schedule A.
3. Certain minimum or fixed costs of syndication make the small project less economic. When a small project is not available for syndication until 15 to 18 months after completion and initial occupancy, these handicaps of small scale make the proposed syndication marginal or infeasible.

SCHEDULE A

CHRONOLOGY OF FAIRVIEW

Fairview is the name of a Section515 family housing development in Killingly (Rogers) Connecticut. Fairview is a plan II Interest Credit project without rental assistance. There are 36 one, two and three bedroom units financed by FmHA mortgage of $1,500,000. Distributions are limited to $7,440 per year.

The developer is Woodfield Limited Partnership, and the only partners are E. G. Yost and Leon Brock as General Partners. Between them they have been developing, syndicating and managing subsidized housing for over 25 years.

Planning of Fairview started in 1983 and an option on the site was obtained on November 8, 1983.

Closing on the construction loan took place in November 1985 and final close with FmHA and initial occupancy took place on August 5, 1986.

A syndicator from Hartford, Connecticut issued a private placement memorandum in April 1986 providing for the sale of Limited Partnership units totalling $400,000, with the limited partners entitled to 95% of the profits and losses. Internal Revenue Service assigned to the tax shelter the Tax Shelter Registration Number 861 330 02732. The entire issue, or close to it, was subscribed and closing of the transaction was scheduled for May 13, 1986. On May 6, 1986, however, the Senate Finance Committee approved a tax reform bill, prompting a supplemental letter to subscribers explaining the effect of changes in the tax code and the right of subscribers to request refund and cancellation of their subscriptions. All of the subscribers cancelled and the syndication died. The direct out of pocket losses to the developers on account of the aborted syndication, chiefly legal and accounting fees, exceeded $32,000.

One or both of the developers were, and will continue to be, in an alternative minimum tax position, with deductions offering a very minimum benefit. Their tax planning always contemplated that the losses from Fairview would not be used as deductions by the developers but would be made available to investor-limited partners to increase the cash generated by the syndication.

July 10, 1987

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
Longworth House Office Building
Washington, D.C. 20515

RE: Technical Corrections Act of 1987
Low Income Housing Transitional Rule

Dear Mr. Chairman:

On behalf of the National Leased Housing Association, which represents state and local housing agencies, developers, and equity investors of low-income housing, and the Council for Rural Housing and Development, which represents developers and equity investors involved in the Farmers Home Administration Section 515 rural housing program, we would like to briefly comment on an aspect of the Technical Corrections Act of 1987, H.R. 2636.

Our comment relates to Section 105 (b)(2) of the Act, pertaining to the transitional rule for certain low income housing projects. We are very pleased with the insertion of this transitional rule in the Technical Corrections Act and very much appreciate the efforts that you made during the debate over the technical corrections resolution that was introduced in the last session of Congress. Our comment on this provision is a highly technical "fine-tuning" one, and should not be interpreted as diminishing the importance of including this rule in the bill.

Under the "Special Rule for Certain Partnerships" as provided in Section 105 (b)(2), a partnership could qualify for transitional relief if, among other things, it placed a property in service on or after December 31 and before August 17, 1986, continuously held such property and, in addition, the partnership was not treated as a new partnership or as terminated at any time on or after December 31, 1985. A problem is created, which we believe was unintentional, for some properties which may have been placed in service during this eight month period, if the partnership placing that property in service was formed any time after December 31, 1985. For example, an otherwise qualified property might have been placed in service on April 1, 1986 and the partnership formed on March 1, 1986. Under the wording of the bill, such a partnership would not qualify, even if it continuously held the property on and after April 1, 1986.

The drafters clearly intended that there be a prohibition on a partnership selling a property or being formed after such a property was placed in service and we understand the policy reasons for that provision. However, in order to accomplish this goal, the partnership formation or termination date should be tied to the placement in service date of the property, not the date December 31, 1985. This formulation would, in our judgment, satisfy the Congressional concern that there be no sales of properties after they have been placed in service if relief were sought under the transition rule. However, it would do so in a manner that would not inadvertantly penalize partnerships which happened to have been formed after December 31, 1985 but before a project was placed in service during this eight month "window period".

Thus, we would ask that the language contained on line 22 of the bill be amended by striking out "December 31, 1985" and inserting in lieu thereof, "the date which the partnership placed such property in service".

We would very much appreciate your consideration of these comments, and the inclusion at the Committee's markup of the amendment which is noted above. Thank you very much.

Very truly yours,

COUNCIL FOR RURAL HOUSING AND DEVELOPMENT

NATIONAL LEASED HOUSING ASSOCIATION

Section 503

CALIFORNIA
FEDERAL

William L. Callender
President and
Chief Executive Officer

July 3, 1987

The Honorable Dan Rostenkowski
House of Representatives
Rayburn House Office Building 2111
Washington, D.C. 20515

Re: Technical Corrections Act of 1987

Dear Mr. Rostenkowski:

Section 503 of the Tax Reform Act of 1986 extended the "at risk" loss limitation rules to deductions resulting from the holding of real property acquired by the use of nonrecourse financing. This change was apparently enacted primarily to prevent the perceived abuse of inflated depreciation deductions arising from overvalued purchase prices. The expanded "at risk" limitations, however, created an exception for certain nonrecourse loans secured by real property where the borrowing is from "any person who is actively and regularly engaged in the business of lending money" ("qualified person"), such as California Federal Savings and Loan Association.

Notwithstanding the general rule that a borrower is considered at risk with respect to nonrecourse real estate financing from a qualified person, the 1986 TRA disqualifies the transaction where the qualified person is related to the borrower or is the seller of the real property. However, Congress apparently further recognized that the potential for tax abuse is negated when the financing is on substantially the same terms as other loans made by lenders regularly engaged in the business of real estate lending. Accordingly, the 1986 TRA provides that qualified nonrecourse real estate financing to a related person will be treated as at risk "if the financing from the related person is commercially reasonable and on substantially the same terms as loans involving unrelated persons". This "commercially reasonable" exception does not, however, apply where the qualified person is also the seller of the real property. Therefore, the 1986 TRA at risk limitations would apply to California Federal's financing of sales of its own repossessed properties on a nonrecourse basis, even if the loan is on a commercially reasonable basis.

Savings and loans are substantially limited by law, regulation and public policy considerations to the business of real estate lending. Unfortunately, however, the 1986 TRA is now operating as a barrier to the long-standing and highly-regulated principal business of this industry.

5670 Wilshire Boulevard Los Angeles, California 90036 Telephone 213 932 2956

Historically, savings and loans have provided financing on most sales of their foreclosed properties. A significant result of the expanded at risk rules will be to substantially aggravate the already existing difficulties and adversities involving the disposition of foreclosed properties by requiring potential purchasers to arrange financing from other lenders unfamiliar with the property. In many, if not most, of such situations, alternative financing will not be readily available because of the nature of the underlying property. These new rules will be particularly prejudicial to savings and loans, such as California Federal, operating in the 10 states where state law prohibits lenders from making recourse loans with respect to such sales.

Certain concerns have been raised that an exception for seller financing by savings and loans of their foreclosed properties would continue the perceived tax abuse from overvalued purchase prices. This is simply not the case. The 1986 TRA changes that eliminate accelerated depreciation methods and extend the useful life from 19 to either 27 1/2 or 31 1/2 years no longer provide a tax incentive to inflate the purchase price with an offsetting economic reduction in the terms of the financing. In addition, the enactment of the passive loss limitation rules provide a significant barrier to the deductibility of any losses from real estate activities notwithstanding the amount at risk by an individual investor.

The issue of qualified person seller financing is of major importance to the savings & loan industry and, on behalf of California Federal, I respectfully request that this issue be favorably addressed in the Technical Corrections legislation or otherwise resolved at the earliest possible time.

Sincerely,

William J. Callender

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July 17, 1987

BY MESSENGER

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act
Interplay of At Risk Rules and
Rehabilitation Tax Credit Amendments

Dear Mr. Leonard:

In connection with your consideration of technical corrections to the Tax Reform Act of 1986 (the "Act"), we are writing to bring to your attention two inconsistencies, and perhaps unintended consequences, of the provisions under Section 503 of the Act relating to the extension to real property of the at risk limitations (the "At Risk Rules"). As you know, by extending to real estate the At Risk Rules contained in Section 465 of the Internal Revenue Code (the "Code"), the at risk rules applicable to tax credits (the "Credit At Risk Rules") contained in Section 46(c)(8) of the Code apply to real estate. See I.R.C. §45(c)(8)(B).

Issue 1. Effect on Rehabilitation Tax Credits of Absence of a Transition Rule Under Section 503 of the Act.

The extension of the At Risk Rules to real property generally applies to losses incurred after December 31, 1986, with respect to property placed in service by a taxpayer after December 31, 1986. Act §503(c). In contrast, amendments made with respect to the rehabilitation tax credit provisions, which are generally effective for property placed in service after December 31, 1986, contain transition rules. Specifically, the amendments to the rehabilitation tax credit provisions do not apply to (1) property placed in service as rehabilitation property before January 1, 1994, if the rehabilitation was completed under a written contract binding on March 1, 1986, and (2) rehabilitation of property (including any leasehold interest) acquired before March 2, 1986 or acquired on or after that date, if (a) the rehabilitation was completed under a written contract binding on March 1, 1986, and a historic certification application was submitted to the Department of the Interior (or its designee) before March 2, 1986, or (b) the lesser of $1,000,000 or 5% of the rehabilitation cost was incurred before March 2, 1986, or is required to be incurred under a written contract binding on March 1, 1986. Act §251(d).

Based upon the foregoing, if the transition rules set forth in Section 251(d) of the Act apply, the reduced rehabilitation credit percentages contained in the Act do not apply. Despite such qualification, however, the taxpayer may not be permitted to utilize the greater amount of rehabilitation credits (or, for that matter, any rehabilitation tax credits) because of the absence of a transition rule under the At Risk Rules set forth in Section 503 of the Act. As a result, in many instances the transition rules under the rehabilitation tax credit rules do not produce a beneficial or intended effect.

For example, if a real estate project otherwise eligible for the grandfather provision provided in Section 251(d) of the Act had financing commitments prior to the Act providing for more than 80% leverage, it would not comply with the 80% test set forth in Section 46(c)(8)(D)(ii)(II) of the Code, described below, and therefore would not generate any rehabilitation tax credits.

As a further illustration, assume the renovation of a shell of a real estate property ("Project") is completed and placed in service in 1986. Assume further that tenant improvements were commenced in late 1986, but will be completed and placed in service in 1987. Because the shell of the Project was placed in service before January 1, 1987, any rehabilitation tax credits generated by it are not subject to the Credit At Risk Rules under Section 46(c)(8) of the Code. However, the tenant improvements will not be placed in service until 1987. Therefore, rehabilitation tax credits generated by the tenant improvements will be subject to the Credit At Risk Rules.

We believe that the purpose of providing a meaningful transition rule with respect to transactions generating rehabilitation tax credits is undermined by the omission of a transition rule in the At Risk Rules set forth in Section 503 of the Act. To eliminate this incongruity, we respectfully suggest that you amend the Technical Corrections Bill to include transition rules relating to Section 503 that are comparable to Section 251 of the Act. Such an amendment would be consistent with Section 209 of the Act, which provides that rehabilitation projects covered by the transition rules contained in Section 251(d) of the Act are exempt from the new extended depreciation periods applicable to real estate.

Issue 2. Effect of Applying to Real Estate the Qualified Commercial Financing Test in Section 46(c)(8)(D) of the Code.

As noted above, by extending to real estate the At Risk Rules contained in Section 465 of the Code, the Credit At Risk Rules contained in Section 46(c)(8) now apply to real estate. Under Section 46(c)(8)(D)(ii)(II), nonrecourse financing may not be included in the credit base if the total amount of nonrecourse debt on the property exceeds 80% of what would otherwise be the credit base of the property (the "80% Test"). Under Section 47(d) of the Code, the 80% Test will result in recapture of rehabilitation tax credits at any time in which indebtedness on a building is increased above 80%. Such a consequence would occur even though a taxpayer who sells (rather than refinances) a building would be subject to a declining amount of recapture during each of the first five years of ownership and no recapture after the fifth year of ownership. *See* I.R.C. §47(a)(5).

To eliminate the foregoing incongruous result, we respectfully suggest that you amend Section 47(d) of the Code as part of the Technical Corrections Bill to provide for a reduction or phase-out of investment tax credit recapture realized upon an increase in nonqualified nonrecourse financing. Such a reduction would be consistent with Section 47(a)(5) of the Code, which provides for a reduction or phase-out of investment tax credit recapture if a taxpayer sells property which generated investment tax credits.

If you have any questions or require additional information concerning this matter, please contact the undersigned.

Respectfully submitted,

Steven S. Snider

Steven S. Snider

ROBERT T. MATSUI
THIRD DISTRICT, CALIFORNIA

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Congreſs of the United States
House of Representatives
Washington, DC 20515

July 10, 1987

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
1100 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

It has recently been brought to may attention that the 1986 Tax Reform Act contains a provision which, without amendment, impedes financial institutions, such as savings and loan associations, from disposing of repossessed properties.

As I understand the problem, the extension of the "at risk" loss limitation rules to deductions resulting from the holding of real property acquired by non-recourse financing essentially precludes a savings and loan from financing sales of real estate from its portfolio of repossessed properties on a non-recourse basis, even if the loan is on commercially reasonable terms.

As you aware, several exceptions were provided in the extension of the at risk rules to real estate, including a provision which allows non-recourse financing from a qualified lender who is related to the purchases of the property, so long as the loan is commercially reasonable. I believe that another exception is necessary in order to permit savings and loan associations to provide non-recourse financing on a commercially reasonable basis when repossessed properties are sold from their own portfolio.

I hope that you and your staff will give this matter considertion for inclusion in the Technical Corrections Act of 1987.

Very truly yours,

Bob

ROBERT T. MATSUI
Member of Congress

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July 14, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Rob:

I would like to bring to your attention an issue involving the "at-risk" rules of newly-amended Code section 465 that requires clarification as the Congress considers H.R. 2636, the Technical Corrections Act of 1987.

Generally, the Tax Reform Act of 1986 extended the limitations of the "at-risk" rules of Code section 465 to non-recourse financing secured by real estate. Congress enacted this extension in order to limit the opportunity for overvaluation of real property, and to prevent the transfer of tax benefits arising from real estate activities to taxpayers with little or no real equity in the property. Because non-recourse financing provided by a third party commercial lender does not raise these concerns, Congress created an exception to this new rule for real estate non-recourse financing borrowed from a "qualified person". For purposes of this exception, a "qualified person" is defined as "any person which is actively and regularly engaged in the business of lending money."

Although the situation described below is substantially similar to the types of non-recourse borrowing that Congress excluded from the extension of the at-risk rules, it technically falls outside the qualified person exception. It is therefore urged that an amendment be made to the qualified person definition broadening its scope to include non-recourse borrowing where the concerns underlying the at-risk rules are not implicated.

Frequently, partnerships will obtain traditional real estate financing from institutional lenders such as insurance companies and commercial banks who clearly satisfy the definition of a qualified person. For a variety of non-tax and non-accounting reasons, however, it is often not possible or not desirable for the institutional lender to extend the financing directly to the partnership. For example, some states, such as New York, restrict insurers' ability to make loans to entities other than corporations. See Article 5, Section 81, New York Insurance Law, recodified at, Article 14, Section 1404 (statute enumerates permissible classes of investment for insurance company reserves (e.g., government obligations, corporate obligations, certain preferred stock, etc.)*/ Other states that have imposed similar restrictions on insurance company investments include California, Colorado, Connecticut, Florida, Iowa, Maine, Massachusetts, Minnesota, Pennsylvania and Virginia.

In other cases, partnerships have sought to protect partners against loss in the event of foreclosure where such partners have pledged their promissory notes as collateral. In such cases it is desirable to have an entity other than the partnership incur the indebtedness.

In order to avoid such problems, partnerships will frequently seek to interpose a corporate intermediary in the borrowing transaction. To accomplish this result, the parties will often use a structure similar to the following:

> A partnership will issue and sell its own note and mortgage to a specially-formed corporation that is owned by an unrelated third party (typically the intermediate corporation is owned by a company such as U.S. Corporation Co. or Prentice-Hall Services which provide general corporation services to the public). The intermediate corporation will simultaneously issue and sell its own note--secured by the partnership's note and mortgage--to the institutional lender.

Economically, these loan transactions are of no consequence to the intermediate corporation, and the benefits and burdens run from the institutional lender to the partnership. Despite the economic substance of these related transactions, the partnerships, in form, borrow money from the intermediate corporations which, by the very nature of their special purpose creation, are not "actively and regularly" engaged in the lending business as required by the new amendments to the at-risk rules.

It is readily evident that the source of non-recourse financing in each such transaction is a "qualified person" for purposes of the at-risk rule exception. Unfortunately, because of the structure that is either necessitated by state law regulatory requirements or selected based upon valid non-tax considerations, these transactions currently fall within the general limitations of newly-amended Code section 465.**/ It is clear, however, that the concerns underlying the general extension of the at-risk rules to non-recourse financed real estate are not implicated in the transactions at issue.

I have attached suggested statutory language that would resolve this technical problem by amending the definition of "qualified person" to include intermediate corporations involved in "back to back loan" transactions. This is the equitable result given that the form of the transaction is dictated by non-tax considerations.

---

*/ In September, 1983, this law was partially amended to permit certain insurers to make loans directly to partnerships.

**/ Although the amendments to the at-risk rules do not apply to partnership interests acquired before January 1, 1987, they do apply to subsequent transfers of such interests even though the property was placed in service at an earlier date.

Please do not hesitate to call if you have any questions or comments with regard to the above.

Sincerely,

John J. Salmon

MODIFICATION OF AT RISK LIMITATION ON REAL PROPERTY

(a) General rule - Section 465(b)(6)(D) is amended by adding at the end thereof the following new clause:

"(iii) Back to Back Loan Transactions - For purposes of clause (i) a corporation shall be treated as actively and regularly engaged in the business of lending money under section 46(c)(8)(D)(iv) if -

(I) such corporation borrows money from one or more 'qualified persons' (as determined without regard to this clause) and simultaneously lends the aggregate principal amount borrowed to another person pursuant to terms such that the aggregate amount periodically receivable with respect to the amount loaned by the corporation is equal to the aggregate amount payable, on or about the same dates, with respect to the amount borrowed by the corporation,

(II) such corporation does not engage in any activities other than those described in subclause (I) above, and

(III) the use of the corporation as an intermediary in the transaction described in subclause (I) does not have as one of its purposes the avoidance of Federal income tax."

Section 511

Written comment
Technical Corrections Bill of 1987 (HR 2636)

Charles T. Peterson, Jr.
Vice President-Probate/Tax Department
Bank One, Dayton, NA
Kettering Tower
Dayton, Ohio 45401

My name is Charles T. Peterson, Jr. I am a lawyer, admitted to the bars of Pennsylvania and Ohio, head of the Probate/Tax Department at Bank One, Dayton, NA, former IRS agent. Annually I oversee the preparation of over 1600 fiduciary and personal income tax returns.

Section 105(c) of the Technical Corrections Bill of 1987 makes a substantitive change in the definition of "investment income" striking out "incurred or continued to purchase or carry" and substituting "properly allocable to " The proposed change is more than technical since it alters the method of linking interest expense to investment income making such linkage more difficult to establish and eliminating the availability of such a connection to continue to carry such an investment.

Tracing is not good tax policy and places an unnecessarily heavy burden on taxpayers. In the real world people do not borrow $10,000 and carry the check to a broker to make a $10,000. investment. There is always some slippage of amounts making neat matches impossible. In the real world people do borrow on margin accounts or secure personal debt with liens against investments. Such linkage should be adequate to establish the connection and prevent the inequity of disallowing the deduction when the only incident has been the substitution of debt. The latter would be the casualty of eliminating the words "continued" and "carry". Difficulty in compliance makes for needless litigation. Please see attached article from the Wall Street Journal, page 27, July 7, 1987.

For these reasons: (1) the change is substantive, not technical; (2) the change will work inequities; (3) the change will be administratively difficult to enforce or to comply with; (4) the change will engender unnecessary litigation, I urge you not to change the Internal Revenue Code of 1986 definition of investment income

HIGHLIGHTS SECTION 2

Who's News: Gerber chief's death re-ignites takeover rumors, Page 29.

Currencies: British pound surges on rising tensions in Persian Gulf, 35.

Credit Markets: Bond rally fizzles as dollar gives up early gains, 36.

Politics: Which Col. North will tell his story to the nation? 52.

'aper Trails: Interest Deductions 1ade More Complex by IRS Rules

YOUR MONEY MATTERS

By Barbara Rosewicz
And Rose Gutfeld
Reporters of The Wall Street Journal

New tax regulations heap a compli- ted paperwork burden on investors and nall-business executives who borrow— d could cost them tax deductions for terest expenses.

"It's the upper middle class that's go- ng to have problems," predicts Larry xelrod, a partner at Touche Ross & Co. lany wealthy people will be able to ma- euver around the rules, he says, and low nd moderate-income taxpayers generally won't be affected.

Tax accountants are already devising ways for taxpayers to avoid pitfalls posed by the interest-deduction regulations that were proposed last week by the Internal Revenue Service to take effect beginning with the 1987 tax year.

The regulations, which put the tax law into effect, usher in a new concept for borrowers: Deductions for interest paid on non-mortgage loans depend upon how the borrowed money is used. Previously, interest was generally deductible no matter how a loan was spent—unless it went for tax-exempt investments.

Taxpayers now must trace how they use a loan from the day they take it out until it's repaid. Their tax bill will depend on how the loan was used each day.

For example, a taxpayer borrows $10,000, puts it in a checking account and, later in the year, uses it to invest in a limited partnership and to buy a car. In the IRS's eyes, the single loan has generated three kinds of interest: investment interest, passive-activity interest and personal interest. Taxpayers will have to account for each kind of interest payment separately.

Among investors, those hardest hit by the rules are those who borrow to buy stocks and bonds or make so-called passive-activity investments like limited partnerships or certain rental property.

Among small-business executives, those most affected are partners in "S corporations," or sole proprietors—particularly those who take out lines of credit or who finance equipment or inventory. Mortgages, home-equity loans that are within deductibility limits and corporate debt aren't affected.

The regulations carry out tax-law changes that phase out deductions over five years for interest paid on personal debts, such as car loans and credit-card bills, but preserve full deductions for interest on business or trade loans. Passive-activity interest, meanwhile, is now generally deductible only to the extent a taxpayer has passive-activity income. And investment interest is deductible only to the extent the taxpayer has investment income.

Tax-Break Tips

Tax accountants suggest the following moves to simplify record keeping or to keep from losing tax breaks:

- **Keep separate accounts for personal, business and investment use, though it may run up additional banking fees.**
- **Pay off old debts that are now being used for any of several purposes and start anew with segregated accounts.**
- **Make sure debts incurred for investments can be traced to the investment, such as by observing the 15-day rule or taking out the loan with a check payable to a third party, such as a broker.**
- **Consider home-equity loans, which don't require as much record keeping and are fully tax deductible, as long as all mortgages don't exceed the cost of the house plus improvements.**
- **Refrain from writing checks on stock-margin accounts for purposes other than buying stock.**

THE 15-DAY RULE

A taxpayer who spends the proceeds of a loan within 15 days of taking it in cash or of depositing it in a regular account automatically qualifies for the appropriate deduction. For loan proceeds that sit longer than 15 days, however, the IRS will base the deduction eligibility on the first purchase made with the cash or from the account financed by borrowed funds. In some cases, that could cost a taxpayer the full benefit of a deduction and is what Phil Wiesner of the accounting firm Peat Marwick Main & Co. calls "a trap for the unwary."

For example, a taxpayer borrows $1,000 with a stock investment in mind and puts the money into an account with $1,000 of unborrowed money on May 1. On June 17, he writes a check for $800 to buy a refrigerator. On June 26, he writes a $1,000 check to make his stock purchase. Because he waited more than 15 days to spend the loan, the IRS no longer would allow the taxpayer simply to designate how the proceeds were spent. Instead, the IRS would count the refrigerator as the first purchase from the borrowed funds. Thus, $800 of his loan would be construed as used for a consumer purchase, eligible for only a 65% tax deduction in 1987. Only $200 would be seen as investment interest, eligible for a 100% deduction.

LINES OF CREDIT

The rules treat each borrowing under a single line of credit as a separate debt if the loan has a variable interest rate that has changed since the previous borrowing. The rules also specify that first repayments are considered to pay back the first borrowing made under the credit line.

Lines of credit typically are used by small-business executive with cyclical operations, such as retailers who have a big Christmas selling seasons or construction businesses that can't operate in bad weather. Either new provision can result in the loss of a portion of a loan's deductibility for this type of borrower.

For example, the owner of a small landscaping company gets a line of credit at an interest rate pegged to the prime rate. On Jan. 1, she draws down $30,000, using $20,000 for her family's trip to Disneyland and $10,000 to buy shrubbery, an allowable business expense. On Feb. 1, she draws down $20,000 more, using $15,000 for personal items and $5,000 to pay business expenses. On July 1, she pays back $40,000.

Because the interest rate stays at 10%, the IRS would treat all the borrowing as a single loan and the repayment as paying off, first, all the personal borrowing and then the business debt. Thus, the $40,000 would repay all $35,000 in personal borrowing and $5,000 in business debt, leaving the taxpayer with $10,000 of business debt.

It also would leave the taxpayer with $1,600 of personal interest for the year that isn't fully deductible and $1,200 of business interest expense that is, according to an analysis by Coopers & Lybrand.

But the landscaper may be less fortunate if the prime rate rises—or falls—between fund withdrawals. If the interest rate on the loan rises to 11% by Feb. 1, her second withdrawal will be treated as a separate borrowing. And her $40,000 repayment will go to pay back all the first debt, for the trip and the shrubbery.

After the repayment in this case, the taxpayer is worse off. She is left with $5,000 of personal debt and $5,000 of business debt. For the year, she has $1,960 in personal interest that isn't fully deductible and $1,000 in fully deductible business interest, according to Coopers & Lybrand.

SALE OF ASSETS

The rules state that when a loan is used to buy a business asset, the taxpayer may lose some of the deduction if the asset is sold or transferred to nonbusiness use.

For example, a sole proprietor takes out a business loan to buy a car for his business. Interest on the loan is fully deductible as business interest. Then, however, he transfers the car to his family's use. Even though the car was purchased with a fully deductible business loan, the remaining interest on that loan stops being fully deductible as soon as the car becomes a personal item.

This same provision can work in the taxpayer's favor, however, if the businessman sells his personal car bought with a personal loan and uses the proceeds to buy stock. The remaining interest on what had been a personal loan with only limited deductions becomes an investment loan eligible for greater deductions.

The regulations will apply to the 1987 tax year, even though they are still subject to change before final adoption. Moreover, the IRS warns that it is considering adopting additional rules to prevent abuse of the interest-deduction regulations.

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PHILIP GALLOP (1908-1984)

July 2, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1987--Suggested Technical Corrections to Section 467 of the Internal Revenue Code of 1986

Dear Mr. Leonard:

Section 467 of the Internal Revenue Code of 1986 relates to certain payments for the use of property or services. In section 467(e)(3), certain statutory recovery periods are provided. I raise for your consideration whether this provision should be amended to reflect the changes made in section 168 relating to the new ACRS rules. In particular, I raise the question of whether the statutory recovery period set forth in section 467(e)(3) with respect to residential rental property and nonresidential real property should be increased to reflect the periods set forth in section 168.

Sincerely,

John P. Barrie

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REFER TO FILE# 8728

July 16, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

VIA: FEDERAL EXPRESS

RE: Technical Corrections Bill of 1987 (H.R. 2636);
I.R.C. §163(d) Carry-Forward Accounts

Dear Mr. Leonard:

I am writing to you in order to bring to your attention a problem which involves the interaction of I.R.C. §163(d) and §469, as amended or enacted by the Tax Reform Act of 1986, and the previously existing §163(d). Specifically, the interaction of these provisions produces an arbitrary effect on investment interest carry-overs under I.R.C. §163(d), which appears to be wholly unintended. Throughout this letter when we refer to investment interest deductions we are not referring to construction period interest.

I have closely reviewed the investment interest limitation provisions in this regard, and my office has informally contacted staff members of the Joint Committee on Taxation to discuss the intent and scope of these provisions. The question involved is a highly technical one, however, it does have the potential for working an apparently unintended hardship on certain particular taxpayers, including one of my clients. We are therefore contacting the Committee on Ways and Means in the hope of obtaining some relief, because the status of carry-over accounts under the previously existing I.R.C. §163(d) was apparently not considered at the time that major changes were made to this section under the Tax Reform Act.

Section 163(d) previously prevented a taxpayer from deducting interest expenses used to purchase or carry investment assets to the extent that these interest expenses exceeded the sum of "net investment income" (gross investment income minus other investment expenses) plus $10,000. Any interest expenses made non-deductible by this subsection could be carried forward and deducted in the following year, subject to the same limitation of net investment income plus $10,000. Real estate properties subject to a net lease were generally included within the definition of property held for investment.

The Tax Reform Act of 1986 added §469 to the Internal Revenue Code. This section generally prevents a taxpayer from claiming deductions from passive activities to the extent they exceed his positive income from passive activities. Rental activities, including net leased real estate, are included within the definition of a passive activity.

Section 469 has to some extent therefore subsumed §163(d) by applying even stricter limitations on deductions which were previously limited by this other section.

At the same time that Congress added §469, it also amended §163(d). One of these amendments specifies that §163(d) does not apply to any interest which is taken into account under §469 with respect to a passive activity. On the other hand, the scope of §163(d) has been expanded somewhat by including within the definition of property held for investment those assets which yield portfolio income under I.R.C. §469(e).

The changes made by the Tax Reform Act of 1986 raise the question as to whether the interest expense deductions suspended under the old §163(d) and carried forward, which are attributable to real estate investments subject to a net lease, should after 1986 be carried over and used in the computation of the taxpayer's passive loss limitation under §469. The alternative would be to carry this suspense account forward to the new §163(d). The old and the new versions of the investment interest limitation are radically different, though they bear the same numerical section designation. Most notably, interest expenses from net leased real estate were subject to the previous version of §163(d), while they are not subject to the new version of this same section.

Although a carry forward into §469 for real estate interest expenses suspended by the old §163(d) appears logical, and would be entirely compatible with the purposes of the new §163(d) and §469, there appears to be no statutory authority for this proposition. Moreover, such a carry forward is arguably prohibited by the transition rule of §501(c)(2) of the Tax Reform Act of 1986, which bars any part of I.R.C. §469 from applying to losses carried forward from previous years.

In the course of the conversations we have had with some legislative aides on this topic, it was suggested that §501(c)(2) was intended as a relief measure for taxpayers. In this case, however, its effect appears to be quite different.

The result of the interaction of these various parts of the law is to work a hardship on certain taxpayers, and appears to violate the policy of matching income with expenses, which underlies some of the most important changes made by the Tax Reform Act of 1986.

It has been suggested that the affected taxpayers could still make use of the carry-forward losses by netting them against income from portfolio assets, such as bonds and other interest-producing assets. As a practical matter, however, this provides little or no relief for taxpayers involved in real estate development. The interest carrying expenses are perhaps the most significant of all costs incurred by real estate developers, even above the cost of construction. Although a large portion of these interest expenses were suspended by the old §163(d), these deductions should be allowed against the gain realized on the property when it is sold.

Some taxpayers may never be able to make use of the deductions for interest expenses which were in fact previously paid. Producing sufficient portfolio income to make use of the suspended deductions would require huge amounts of investment capital. This would prove very difficult for those taxpayers whose assets are already devoted to the same real estate activities which produced the interest suspense accounts.

I can appreciate that the members of the Committee are now under substantial pressure to restore the many tax benefits previously enjoyed by real estate activities. I believe that the matter I have raised here is of an entirely different character, in that we are not seeking to use real estate deductions to offset income from other sources, or to shelter cash flow from real estate investments. Instead, we wish to be able to make use of suspended deductions for amounts which were in fact previously expended, and only to the extent that the real estate investments yield taxable income either from their current operations or at the time of disposition. As the law presently stands, it appears that deductions from real estate operations which were suspended under the old law, will now be sidetracked into a tax accounting category which has no relation to the investment which originally yielded the suspended deductions.

I would therefore request that a provision be inserted into the Technical Corrections Bill of 1987 to amend §501(c)(2) of the Tax Reform Act of 1986 to provide that any deduction suspended under I.R.C. §163(d) prior to 1987 which was attributable to rental activities which are now subject to I.R.C. §469 should be carried forward into the suspense account created by I.R.C. §469(b). Although there might be some question as to which investment interest expense deductions suspended under the old §163(d) were attributable to rental activities, I believe that sufficient guidance on this point is provided by Temporary Regulation §1.163-8T issued by the I.R.S. earlier this month.

If you have any questions concerning our proposal, or if I may in any manner be of assistance, please do not hesitate to contact me, or my associate, John Pritchard.

Yours very truly,

THOMAS S. CARLES

Gibraltar MoneyCenter, Inc.
Member Gibraltar Financial Group™

Gregory J. Bowcott
Executive Vice President

August 10, 1987

Dan Rostenkowski,
Chairman
COMMITTEE ON WAYS & MEANS
U. S. House of Representatives
LHOB 1102
Washington, D.C. 20515

Dear Mr. Rostenkowski:

It is my understanding that the House Ways and Means Committee is considering restricting or eliminating the deductibility of home equity lending interest, as a possible option to raise revenue.

My company, Gibraltar MoneyCenter, Inc., is currently serving the financial needs of 11,000 families through our home equity lending program. We have made every effort to educate our consumers about the product and how to properly use such loans. To put limitations or to eliminate the ability to deduct the interest will create unnecessary financial hardship for many homeowners, since it is a way to help them liquefy their assets in times of financial need.

I urge you to retain the current deductibility of home equity lending interest.

Sincerely,

GJB:kmn

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June 17, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: HR 2636
Section 105(c)(8)
Proposed Code §163(h)(5)(D)

Dear Mr. Leonard:

I am writing to suggest you insert the words "[within the meaning of paragraph (3)(B)(ii)(I)]" after the word "basis" in proposed §163(h)(5)(D)(ii)(II).

Otherwise, the increase in the amount determined under §163(h)(3)(B)(ii)(I) would be (or could be) calculated by reference to adjusted basis in the hands of transferor spouse. See §1041(b)(2) and Temporary Reg. §1.1041-1T, Q & A 11. I do not think you intend such a result (or ambiguity) in this instance.

In addition, I have a question about the meaning of proposed §163(h)(5)(D)(i)(II). Can the indebtedness be incurred at any time as long as the interest in property is acquired in a §1041 transaction which is incident to a divorce? Or, must the indebtedness be incurred "incident to the divorce" or to effectuate a division of properties in divorce?

Perhaps the language of (D)(i) is sufficient to require the borrowing in (D)(i)(II) to be "incident" to divorce or legal separation. Perhaps it is a question which should be addressed in regulations (if we ever get them) rather than statute. In any event, I have the question, so I am calling it to your attention.

I realize these may be diminutive issues to you, but I am getting increasingly frustrated by tax legislation which raises more questions than it answers. In addition, in my opinion, Congress has been abdicating its legislative responsibility by writing increasingly vague statute and giving Treasury the power of God to issue regulations ..... "to carry out the purposes of this section."

On the other hand, if the tax-writing staff had more input from practitioners (assuming Congressional Committees allowed time for comment) prior to first passage, maybe so many technical corrections would not be necessary.

I hope my comments are helpful. At least I feel that maybe this letter will eliminate the need for another technical correction.

Very truly yours,

David A. Rooney, CPA

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July 17, 1987

By Hand
Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: 1987 Technical Corrections Bill (H.R. 2636)

Dear Mr. Leonard:

Section 511(b) of the 1986 Tax Reform Act amended Section 163 of the 1986 Internal Revenue Code to disallow personal interest deductions for noncorporate taxpayers. However, personal interest does not include qualified residence interest. Code Section 163 and Section 105(c) of the 1987 Technical Corrections Bill do not explicitly state that interest paid or accrued on indebtedness secured by a qualified residence which is under construction shall constitute qualified residence interest.

To remove any uncertainty, Code Section 163(h)(5)(A) should be corrected to include the following language:

> Interest paid or accrued on indebtedness incurred or continued in the construction of property to be used as a qualified residence shall be treated as qualified residence interest.

This suggested language is based on Section 163(d)(4)(B) of the 1954 Internal Revenue Code, prior to its amendment by the 1986 Tax Reform Act.

Respectfully,
SEIDMAN & SEIDMAN/BDO

Mario P. Borini

Mario P. Borini, CPA, PhD
National Director of
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July 15, 1987

Mr. Robert Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1986
Interest Expense Deductions

Dear Mr. Leonard:

This letter discusses technical corrections pertaining to interest expense deductions.

One question is the treatment of interest that is both trade or business interest and qualified residence interest. In most cases it will not matter which provision governs the deduction of such interest but in some cases the distinction is significant. A taxpayer may prefer to treat such interest as trade or business interest in order to secure a net operating loss deduction. In other circumstances, a taxpayer may wish to deduct the interest as qualified residence interest because it would otherwise be allocable to a foreign trade or business and reduce the foreign tax credit. Perhaps the present rules can be interpreted to give the taxpayer a choice as to how to treat such interest, and perhaps this is intended, but it appears likely that this question has simply escaped consideration.

In determining which rule to specify for such interest, there are several considerations. One is that a taxpayer should not be penalized with loss of a net operating loss deduction simply because a business loan has been secured with a personal residence. Hence it would be inappropriate to require that such interest be deducted as qualified residence interest. A closer question is presented in the reverse circumstance where the taxpayer benefits from deducting the interest as qualified residence interest. It might be argued that a taxpayer should not be able to achieve a better tax result as to trade or business interest by having the debt secured by his home. Yet this is precisely the result that obtains with regard to investment interest (IRC § 163(d)(3)(B)(i)) and passive activity interest (IRC § 169(j)(7)). On balance it appears that Congress meant the taxpayer to receive the full benefit of any available qualified residence interest deduction, and that this would entail allowing an election as to the governing provision where such interest also qualifies as a trade or business expense. Regardless of whether this is the correct conclusion, the treatment of such interest should be clarified.

In a similar vein, clarification is needed with respect to qualified housing interest that is directly traceable to the purchase of assets producing tax-exempt income. As things stand now, there may be some question as to whether section 163 prevails over section 265.

Under prior law, personal interest was deductible without regard to whether the related debt was secured by a residence. Borrowings to purchase or hold exempt obligations were nondeductible. Borrowings for personal purchases, including residences, were not considered to be incurred to hold tax exempt bonds even if such bonds were held by the taxpayer, as long as they were not used for security. By contrast, business borrowings of individuals would be presumed in some circumstances to be incurred for the purpose of carrying exempt obligations. See Rev. Proc. 72-18, 1972-1 C.B. 740. It appears that Congress intended to preserve the full extent of prior law benefits regarding qualified residence interest, but there does not appear to be an intent to extend those benefits beyond prior law. Hence the appropriate clarification here should be to the effect that qualified residence interest will be nondeductible under section 265 if incurred for the purchase of exempt obligations, but that section 265 will not intrude where qualified residence interest is incurred for personal purposes by a taxpayer holding exempt obligations. Prior law should govern qualified residence interest incurred for business purposes by a taxpayer holding exempt obligations.

One more change in the interest provisions seems appropriate. The change relates to taxpayers with grandfathered loans in excess of their basis in their residences. Such taxpayers should be permitted to deduct as qualified residence interest the interest on additional borrowings to the extent the proceeds are used for expenditures that increase their basis in their homes.

> **Example:** Mr. Smith owns a home he bought for $30,000. On August 16, 1986 he owed $50,000 in mortgage debt on the home. Because the mortgage debt is grandfathered, he is entitled to deduct interest on the entire debt. If he wants to borrow an additional $15,000 to be secured by the home, with the proceeds to be used for a home improvement, he should be allowed to deduct the interest.

A contrary rule would lead to the undesirable and illogical result that persons with grandfathered loans are the only taxpayers who cannot deduct interest on home improvements. Without a clarifying amendment, the provisions of the 1986 Act can be interpreted to require this result.

Very truly yours,

Kaye A. Thomas

Weyerhaeuser Company

Neil P. Wissing
Vice President and
Director of Taxes

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August 3, 1987

Robert J. Leonard
Chief Tax Counsel
Ways & Means Committee
1102 LHOB
Washington, D. C. 20515-6348

Dear Rob:

It recently came to my attention that TRA '86 inadvertently eliminated the deductibility of mortgage interest during the construction period of a principal or second residence. I believe that it is clear that the Members did not intend that result.

I'm attaching a brief paper which describes why the deduction is apparently eliminated. If this is indeed the result, it will both come as a substantial shock to taxpayers constructing new dwellings and interfere with liquidity in the housing market.

Let me urge you to correct this item when the Technical Corrections Act is before the Committee.

Warm regards,

Enclosure

POTENTIAL DENIAL OF MORTGATE INTEREST DURING RESIDENCE CONSTRUCTION PHASE

When Congress prohibited consumer interest deductions in the Tax Reform Act of 1986, an explicit exemption was made for interest paid on debt incurred on principal and secondary personal residences ("qualified residences").

Apparently in an effort to minimize legislative drafting time, "qualified residence" was defined by specific cross-reference to sections 1034 and 280A(d)(1) for principal and secondary residences, respectively.

Both Section 1034 and Section 280A mandate occupancy (or "use") as a condition of qualification as a principal or secondary residence.

Accordingly, there exists a period of time when the interest on a "qualified residence" may, technically, not qualify for deduction by virtue of the cross-reference definitions under sections 1034 and 28A. This would occur when a lender advances funds ("drawdowns") under a construction financing agreement or mortgage. Because a "qualified residence" is defined as one which is occupied or used, the potential primary or secondary residence in the process of construction would apparently not qualify for interest deductions.

Clearly, the above result was never the intent of Congress. Further, the Technical Corrections Act of 1987, which could have afforded protection to taxpayers in a construction mode, appears to reinforce the unintended results originally enacted in TRA '86.

When the Technical Corrections Act is taken up by the tax-writing committees, it should be amended to make it absolutely clear that interest on a construction loan for a principal or secondary residence is deductible by the owning taxpayer.

There may be possible concern regarding the potential of overlapping interest deductions on three pieces of property, assuming a taxpayer owns both a principal and second residence during the time a new principal or second residence is being constructed. This would appear to be a harsh basis for denying the deduction to the population at large, particularly when the high incidence of "first-time buyers" in the home construction market is considered.

More importantly, correction of the '86 Act would not appear to thwart the underlying intent of Congress to limit interest deductions to only principal and second residences. All of the "deductible interest" would appear to apply to what could generically be described as the taxpayer's principal or second residence. Surely, it would not be necessary to further clutter the Code by inserting specific limitations to provide for potential "triple" interest deductions.

It may also be desirable to incorporate a "recapture" of the interest deduction on the dwelling under construction to cover the situation where the taxpayer, for whatever reason, does not eventually occupy the dwelling under construction.

8/3/87

Title VI, Comments on more than one section

STATEMENT OF CATHERINE L. HERON

This statement is submitted to the Ways & Means Committee of the United States House of Representatives by Catherine L. Heron, Deputy General Counsel of the Investment Company Institute,[1] on behalf of the Institute and its members to express the Institute's concerns regarding certain provisions of H.R. 2636, the Technical Corrections Act of 1987 ("the Technical Corrections Bill"), that affect the tax treatment of regulated investment companies and their shareholders and to propose certain additional technical changes to the Tax Reform Act of 1986 ("the 1986 Act").

I. Proposed Amendment to I.R.C. Section 851(b)(3) To Include Foreign Currency Gains

Regulated investment companies ("RICs") satisfying the requirements of Subchapter M of the Internal Revenue Code ("the Code") are not subject to a corporate level income tax to the extent that they distribute their income to shareholders on a current basis. Among the requirements that must be satisfied is the requirement of Section 851(b)(3) that less than 30% of a RIC's gross income be derived from gain on the sale or other disposition of stock or securities held for less than three months. This requirement is sometimes referred to as the "short-short test." Despite industry efforts, supported by the Treasury Department, to have this provision repealed as part of the 1986 Act, the provision was retained.[2]

The Technical Corrections Bill would substantially amend Section 851(b)(3) to expand the types of property that would be covered by the short-short test. Under the Technical Corrections Bill, Section 851(b)(3) would be revised to require that:

> "(3) less than 30 percent of [the RIC's] gross income is derived from the sale or disposition of any of the following which was held for less than 3 months:
>
> "(A) stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended),
>
> "(B) options, futures, or forward contracts, or
>
> "(C) except as provided in regulations, foreign currency, . . ."

The obvious genesis of this proposed change is the change made by the 1986 Act to Section 851(b)(2), a separate requirement under Subchapter M requiring that 90% of a RIC's gross income be derived from certain sources. Before the 1986 Act, these sources were limited to dividends, interest, gains from the sale of stock or securities and payments with respect to securities loans. The 1986 Act clarified and expanded these permitted sources by:

---

[1] The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 2,086 open-end investment companies ("mutual funds"), their investment advisers and underwriters. Its mutual fund members have assets of about $782 billion, accounting for approximately 90% of total industry assets, and have over 20 million shareholders. The Institute also represents the unit investment trust industry. Separate comments are being filed by David Silver, President of the Institute, on a proposed technical amendment to Code Section 67(c).

[2] There is currently pending a bill (H.R. 2295) which would repeal this provision.

1) expressly providing that the term "securities" has the meaning given that term under the Investment Company Act of 1940,

2) providing that foreign currency gains are an appropriate source of income subject to Treasury's regulatory authority to exclude foreign currency gains that are not ancillary to a RIC's business of investing in stock or securities, and

3) adding a residual class of qualifying income described as "other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [the RIC's] business of investing in . . . stock, securities or currencies."

The proposed amendments to Section 851(b)(3) reflect an attempt to conform that section to Section 851(b)(2) as amended by the 1986 Act. Conceptually, it may generally be appropriate to subject the investments that give rise to qualifying income under Section 851(b)(2) to the rigors of Section 851(b)(3). Foreign currencies, however, are not merely an additional investment product that a RIC is permitted to invest in like stock and securities. Foreign currencies, under the ancillary concept of Section 851(b)(2), are sui generis and are qualifying merely because they are the means of effecting investments in foreign currency denominated stocks and securities.

From the tax policy point of view there is no reason why a RIC should fail to qualify for Subchapter M treatment, and thus be subject to the full corporate level tax, as a result of foreign currency transactions that are ancillary to the RIC's business of investing in stock or securities. As the Treasury stated in its February 5, 1986, letter to Congressman Flippo supporting the expansion of Section 851(b)(2) to include currency gains, such gains are an inherent part of investing in foreign currency denominated stock and securities. This is true both because the RIC has to buy and sell foreign currencies in order to make (and liquidate) investments in foreign currency denominated stock and securities and because, as the Treasury letter noted, it is appropriate for a RIC to use currency positions to hedge the currency risk associated with investments in foreign currency denominated stock or securities. The ability to utilize such hedges to protect the value of a RIC's portfolio assets, as well as to reduce its exposure to currency fluctuation between the trade date and settlement date on the purchase or sale of foreign stock and securities, is absolutely essential in light of the dramatic currency fluctuations that can and often do occur over very short periods of time.

The Institute firmly believes that Treasury's authority to treat currency gains that are not ancillary to a RIC's business of investing in stock or securities as nonqualifying income under Section 851(b)(2) is a sufficient "governor" to prevent inappropriate investments or speculation by RICs in foreign currency. If such gains are ancillary to the RIC's business of investing in stock or securities, there is no reason to disqualify a RIC from Subchapter M merely because the currency gains are derived in less than three months. And if such gains are not so ancillary, they properly constitute nonqualifying income under Section 851(b)(2) and may subject a RIC to disqualification under that provision.

Currency gains can arise in myriad contexts and because of the nature of investments in foreign stocks or securities often arise in a very short time frame. For example, a RIC may sell a bond denominated in Deutsch marks and place the proceeds in a bank account with the expectation that it will use these funds to purchase another security shortly. A week later, the RIC may use these amounts to purchase another bond denominated in Deutsch marks, or, alternatively, may use the marks to purchase Swiss francs which in turn will be used to purchase a bond denominated in Swiss francs. During the week that the RIC is holding the Deutsch marks, they may appreciate (or depreciate) significantly vis-a-vis the U.S. dollar. Surely this "currency gain" should not put the RIC at risk of losing its status under Subchapter M.

As another example, consider a RIC that invests in short-term commercial paper denominated in a foreign currency. When that obligation matures, the RIC will have a foreign currency gain if the currency has appreciated. Similar investments are made by RICs in U.S. commercial paper without any risk of losing Subchapter M status and there is no reason why investing in foreign commercial paper should jeopardize the RIC's status under Subchapter M.

RICs also generally hedge their currency exposure from trade date to settlement date by entering into a currency forward contract to buy or sell the requisite amount of the foreign currency on the settlement date. Again there may be significant fluctuations in the value of the currency during the life of the forward contract. Any resulting currency gain should not jeopardize Subchapter M treatment for the RIC.

The foregoing examples are relatively simple and straightforward. In practice, there are many other, much more complex situations in which currency gains may arise. Subjecting these gains to Section 851(b)(3), or attempting to delineate which types of currency gains must be taken into account for purposes of Section 851(b)(3) and which types of currency gains are exempted, would create an impractical, and probably unworkable, system.

If Congress determines that it is necessary to expand the short-short test to include certain foreign currency gains, any such expansion should be implemented on a prospective basis only. A retroactive application of such a change to taxable years beginning after October 22, 1986 (the date of enactment of the 1986 Act) could result in the disqualification of RICs under Subchapter M without reasonable notice. The 1986 Act, and accompanying legislative history, contain no indication that Section 851(b)(3) would be expanded to cover foreign currency gains. Even the Joint Committee Explanation of the 1986 Act ("the Blue Book"), which came out in May of this year, gives no indication that Section 851(b)(3) would be so changed. The Blue Book did state that Congress intended that the definition of the term "securities" as used in Section 851(b)(3) should be clarified, as it was in Section 851(b)(2), by incorporating the definition of that term in the Investment Company Act of 1940. The Blue Book also noted that a technical correction might be needed to make that change. However, the Blue Book did not in any way suggest that there would be any technical amendments to bring foreign currency gains under Section 851(b)(3). Indeed, by commenting on the intent to have the term "securities" defined the same way in both provisions, the Blue Book effectively implied that further technical corrections to Section 851(b)(3) were not contemplated. Moreover, given the uncertainty of the rules that will evolve under new Section 988 relating to foreign currency gains, particularly the "988 hedging transaction" regulations that Treasury is to draft, as well as the regulations Treasury could draft to exclude certain currency gains from Section 851(b)(3), RICs cannot be expected to know the rules for currency gains under Section 851(b)(3) until such rules are announced. Accordingly, any expansion of Section 851(b)(3) to include currency gains should become effective only after the rules are made known.

In addition, if currency gains are generally made subject to Section 851(b)(3), the regulatory authority to exempt foreign currency gains should be expanded to encompass gains on currency forward contracts, as well as options and futures on currency. There is no reason for gains on any of these derivative currency products to be treated any differently from gains on the underlying currency.

II. Mergers of RICs with Other Investment Companies

Section 106(e)(5) of the Technical Corrections Bill would amend Code Section 337(d) to direct the Treasury to adopt regulations preventing corporations from circumventing the repeal of General Utilities through the use of a RIC or a real estate investment trust (a "REIT"). The Description of the Technical Corrections Bill, prepared by the Staff of the Joint Committee on Taxation ("the Joint Committee Description"), elaborates on the proposed change by stating that the regulations are:

> "to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC . . . in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation."

Joint Committee Description at 48. Since there is no specific effective date provision with respect to this proposed amendment, it would presumably be effective as if included in the 1986 Act. See Section 119 of the Technical Corrections Bill. Conceivably, Treasury regulations implementing this amendment could be made retroactive to the effective date of the repeal of the General Utilities doctrine (generally December 31, 1986).

The proposed amendment, and any regulations thereunder, should be prospective only. As explained below, there was not fair notice that this change in the law was intended and the uncertainty as to how Treasury will implement the provision has a significant chilling effect on the common transactions that may be within its scope. Accordingly, we believe that any change should not be effective until January 1, 1988, thus allowing roughly the same advance notice given with respect to the repeal of General Utilities.

The 1986 Act and accompanying legislative history do not contain adequate notice that mergers, or other tax-free reorganizations, of RICs and other investment companies would give rise to taxable gain on the transfer of assets to a RIC. Indeed, the Conference Report on the 1986 Act states:

> "Neither gain nor loss is recognized, however, with respect to any distribution of property by a corporation to the extent there is nonrecognition of gain or loss to the recipient under the tax-free reorganization provisions of the Code (part III of subchapter C)."

Conference Report at 199-200. This statement of the Conference Committee, which is reflected in Code Section 336(c) as amended by the 1986 Act, suggests that tax-free reorganizations would not be affected by the repeal of General Utilities.

In new Code Section 337(d) Congress did give Treasury regulatory authority to issue regulations to ensure that the purposes of the repeal of General Utilities are not "circumvented" through the use of, inter alia, the tax-free reorganization provisions of Subchapter C. However, there was no indication of how this provision was to be squared with the rule of Section 336(d) that tax-free reorganizations would not be affected by the repeal of General Utilities. Nor was there any indication that Treasury's regulatory authority was intended to reach mergers of RICs with other investment companies. These transactions are and have been common in the industry. We know of an entity that has completed two such transactions since the 1986 Act was enacted and has another such transaction pending. Certainly if these common transactions were suddenly going to give rise to taxable gain, there should have been reasonable notice of such a dramatic change.

The absence of reasonable notice is rather remarkably demonstrated by the fact that on April 13, 1987, the Internal Revenue Service issued a private letter ruling (PLR 8728027) stating that a "C" reorganization of a RIC and a non-RIC investment company would not give rise to any tax liability. The IRS ruling relates to a proposed transaction and thus clearly reflects the IRS's view that nothing in the 1986 Act changed the tax-free treatment of such transactions.

In addition to the lack of notice, the substantial uncertainty as to what Treasury's regulations will provide also argues for a prospective effective date. These uncertainties include the following:

1) Will the tax on the appreciation of the assets transferred to the RIC be imposed at the time of the merger or will it be deferred until the RIC disposes of the assets? We understand that Joint Committee and Treasury staffs contemplate the latter approach, using the new rules of Code Section 1374 on conversion by a corporation from Subchapter C status to Subchapter S status as a guide. Nonetheless, the Joint Committee Description states that Treasury's regulations are to include "rules to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC" in a tax-free reorganization. This statement suggests that the tax will be imposed at the time of the reorganization.

2) If the regulations do provide that the tax will be deferred until the RIC disposes of the assets acquired in the merger, will they also provide that if the RIC retains the assets for 10 years the tax will not be imposed? This is the rule for S corporations under Section 1374, which as noted above the staffs appear to be looking to as a model. Again, however, the language in the Joint Committee Description quoted above suggests that the tax must be imposed in all events.

3) A number of issues arising under Subchapter M would also have to be resolved by regulations. For example, consider a RIC that acquires assets with a carryover basis of $1,000 and a fair market value at the time of the merger of $10,000. Assume either that the tax is imposed at the time of the merger or that the tax is imposed at the time the RIC disposes of the assets and the RIC sells the assets for $10,000. The RIC has $9,000 of built-in gain which is subject to a corporate level tax of approximately $3,000. The RIC has $7,000 remaining to distribute to shareholders, $6,000 of which represents gain and $1,000 of which represents a return of basis.

Will the RIC be subject to a second tax if it does not distribute the full $9,000 of gain realized? Generally, a RIC is entitled to a dividends paid deduction for a distribution of capital gain and is not subject to a corporate level tax on such distributed amounts. However, in the example the RIC has only $7,000 available to distribute. It makes no sense to tax the RIC again on amounts that it could not distribute, but it may not be clear that Treasury has authority to provide for such relief.[3]

If the RIC does distribute the $7,000 to its shareholders, may the RIC designate all $7,000 as a capital gain dividend? Generally a RIC can designate a capital gain dividend up to the amount of the RIC's net capital gain. Here the RIC had a capital gain of $9,000 and should perhaps be permitted to designate all of the $7,000 distribution as a capital gain dividend. Yet $1,000 of the $7,000 really represents a return of principal and should probably not be taxable as a dividend at all. Again it is unclear whether Treasury's regulatory authority is sufficient to reach the appropriate result.

Because of uncertainties such as these, it is difficult for parties to determine what the tax consequences of a merger will be. As a result, there is an understandable reluctance to go forward until at least some of the rules are made known. In order that these transactions not be blocked indefinitely, we urge the Congress to provide that Treasury's regulations will not be effective prior to January 1, 1988, and to make this decision known so that pending and contemplated transactions that may otherwise be subject to the new rules may be completed without undue delay.

III. The Institute's Proposed Technical Corrections to Section 4982

A. Computation of Required Distribution. New Code Section 4982 imposes a 4 percent excise tax on RICs to the extent they do not distribute by the end of each calendar year an amount equal to the sum of (i) 97 percent of their ordinary income for the calendar year, and (ii) 90 percent of their capital gain net income for the twelve-month period ending on October 31 of such year. The purpose of this provision is to reduce the deferral of income recognition by RIC shareholders that may result under the rules of Subchapter M. *See* Blue Book at 376-77.

The distribution requirement with respect to capital gains is less demanding than that for ordinary income primarily because of the relative difficulty of determining the amount of capital gain net income with sufficient accuracy to distribute such amount by the end of the calendar year. Unlike dividend and interest income, which are, by and large, regularly recurring and predictable, capital gains and losses are sporadic and dependent on changing market conditions and other variables. Net ordinary income for the year is also easier to predict because RICs have not traditionally incurred any significant ordinary losses. In contrast, a RIC might well incur capital losses late in the year that could greatly reduce or eliminate capital gains earlier in the year. Finally, gains and losses on capital assets are subject to various rules -- such as the wash sale rule, the straddle rules, and the mark-to-market rules for Section 1256 contracts -- that further complicate (and in many instances preclude) a prompt and accurate determination of capital gain net income.

Under various provisions of the Code, gain (or loss) realized on the sale or exchange of a capital asset is recharacterized as ordinary income (or loss). For example, new Section 988 treats gain or loss on the sale or exchange of a foreign currency denominated bond as ordinary income or loss to the extent the gain or loss on the bond is attributable to

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3/ In the Subchapter S context, somewhat analogous relief is provided by Section 1366(f)(2).

currency fluctuations. Other provisions that alter the character of gain on the sale or exchange of a capital asset include:

(1) Section 1246 (relating to sales of shares in a 50% U.S.-owned foreign investment company);

(2) Sections 1291-1297 (relating to sales of shares in passive foreign investment companies);

(3) Section 1248 (relating to sales of shares in foreign corporations by 10% U.S. shareholders);

(4) Sections 1276-1278 (relating to dispositions of market discount bonds).[4/]

Under Section 4982, it is not clear whether gain or loss on the sale or exchange of a capital asset that is recharacterized as ordinary income or loss under one of the above rules ("the recharacterization rules") would go into the ordinary income basket or the capital gain basket. Section 4982(e)(1) defines ordinary income, for purposes of this provision, as excluding any gain or loss from the sale or exchange of a capital asset. Arguably the recharacterization rules would not be sufficient to override this specific definition, and thus all gain or loss from the sale or exchange of capital assets, including amounts recharacterized as ordinary by one of the recharacterization rules, would go into the capital gain basket. Alternatively, and perhaps more probably, the recharacterization rules could be treated as applicable for purposes of computing ordinary income for purposes of Section 4982.

The reasons behind the less demanding distribution requirement for capital gains are equally applicable to amounts recharacterized as ordinary income (or loss) under the recharacterization rules. The fact that such amounts are recharacterized in no way changes the fact that they are unpredictable and sporadic in occurrence. For example, a year-end gain or loss on a foreign currency denominated bond, treated as ordinary under Section 988, could greatly increase or reduce the ordinary income realized by a RIC for the year. Treating such a currency gain or loss as ordinary income for Section 4982 purposes would thus inject into the ordinary distribution requirement the same unpredictability that led to the less stringent distribution requirement for capital gains.

Accordingly, we recommend that the Technical Corrections Bill be amended to include the following amendment to Section 4982 clarifying that the recharacterization rules do not apply for purposes of Section 4982:

> "Subsection (e) of section 4982 is amended by adding at the end thereof the following new paragraph:
>
> '(5) Treatment of Foreign Currency Gains, Market Discount, etc. --
>
> For purposes of paragraphs (1) and (2), amounts realized on the sale or exchange of a capital asset shall be taken into account in computing capital gain net income (and not ordinary income) without regard to any provision of Chapter 1 that treats such

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[4/] There are additional Code provisions that recharacterize what would otherwise be capital gain as ordinary income, but these are of little significance to RICs. See, e.g., Sections 1245 and 1250 (relating to recapture of depreciation on sale of depreciable property).

amount (or any portion thereof) as ordinary income or loss.'"

We note that under our proposal, the recharacterization rules would continue to apply for all purposes other than Section 4982. Thus, determination of investment company taxable income and net capital gain for income tax purposes would continue to take the recharacterization rules into account, as would the distribution requirements under Subchapter M.

B. Preservation of Earnings and Profits to Support Dividends Paid Deduction. In connection with the adoption of Section 4982, the 1986 Act amended Section 852(c) to provide that a RIC will be treated as having sufficient earnings and profits to support dividend treatment of any distribution treated as a dividend by the RIC. This rule is subject to two limitations: First, earnings and profits are treated as existing under this rule only to the extent necessary to enable the RIC to satisfy the minimum distribution requirements of Section 4982. Second, earnings and profits are not treated as existing under this provision to support dividend treatment in connection with distributions in redemption of stock under Section 302(a).

As explained in the Conference Report, the purpose of this rule is to prevent a RIC from failing to satisfy the distribution requirements of Section 4982 where losses incurred after October 31, but before the close of the RIC's taxable year in which distributions are made, would cause the RIC to have insufficient earnings and profits for its distributions to be treated as dividends. See Conference Report at 244-45. The rule is necessary because under Section 4982 amounts distributed by a RIC are taken into account only to the extent that the RIC receives a dividends paid deduction for the distribution. See Section 4982(c). The dividends paid deduction is, in turn, available only if the RIC has adequate earnings and profits to support treating a distribution (or a portion thereof) as a dividend.

Section 106(1)(3) of the Technical Corrections Bill would amend Code Section 852(c)(2) to provide that for purposes of determining the tax treatment of distributions made by a RIC during any calendar year the earnings and profits of the RIC would be determined without regard to any net capital loss attributable to transactions after October 31 of such year. As in the 1986 Act, this rule applies only to the extent that the amount distributed does not exceed the required distribution for such calendar year under Section 4982. The amendment contained in the Technical Corrections Bill also eliminates the disparate treatment of regular dividend distributions and redemptions contained in the 1986 Act. The Institute strongly supports this aspect of the proposed change.

There is, however, a significant problem with limiting the rule on excluding losses for purposes of computing earnings and profits to net capital losses. While RICs have traditionally not incurred net ordinary losses, the new rules of Section 988 require that foreign currency losses in Section 988 transactions be treated as ordinary. Thus, as noted above, if a RIC sells a foreign currency denominated bond at a loss, the loss will be treated as ordinary to the extent it is attributable to a fluctuation in currency values during the time the RIC held the bond. This is true notwithstanding the fact that the bond is a capital asset in the hands of the RIC.

As a result, it is quite possible that a RIC could incur net ordinary losses that would prevent distributions made earlier in its taxable year from being treated as dividends. This can be illustrated by the case of a RIC with a June 30 fiscal year that has $100 of ordinary income for calendar year 1987 (all of which was earned after June 30, 1987) and distributes $97 in December 1987 to satisfy the

Section 4982 distribution requirement. If the RIC then has a net ordinary loss of $100 during the period from January 1, 1988, through June 30, 1988, it would have no earnings and profits to support the $97 dividend. Under the proposed amendment, the RIC would be subject to the 4% excise tax because it would not be treated as having distributed the $97 it was required to distribute under Section 4982.

Because of this problem, we recommend that in lieu of the amendment contained in the Technical Corrections Bill, Section 852(c)(2) should be amended simply by deleting the language that excludes distributions in redemption from the rule providing that a RIC will be treated as having sufficient earnings and profits to treat as a dividend any distributions that the RIC treats as a dividend. Alternatively, the amendment contained in the Technical Corrections Bill should be modified to provide that net ordinary losses attributable to Section 988 transactions arising in the portion of a RIC's taxable year after December 31, as well as net capital losses occurring after October 31, would not reduce earnings and profits.

IV. Partnerships and Trust Income Under Section 851(b)(2)

As noted in Part I, above, the 1986 Act clarified and expanded the sources of qualifying income for purposes of the requirement under Section 851(b)(2) that 90% of a RIC's gross income be derived from specified sources. One of the changes made by the 1986 Act was the addition of a residual category of qualifying income described as:

> "other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to [the RIC's] business of investing in . . . stock, securities or currencies."

The Technical Corrections Bill would amend the above-quoted language to read as follows:

> "other income (including but not limited to gains from options, futures, or forward contracts, but not including partnership or trust income) derived with respect to its business of investing in such stocks, securities or currencies."

The Technical Corrections Bill does not define "partnership or trust income" and the statutory language on its face is ambiguous. The Joint Committee Description states (at page 56):

> "The bill clarifies that income derived by the RIC from a partnership or trust is not income that is considered to be derived with respect to the RIC's business of investing in stocks, securities or currencies."

Although it is possible to interpret this proposed change as providing that all income derived from partnerships and trusts is nonqualifying income under Section 851(b)(2), it is our understanding that the intent of this change is merely to provide that income from such interests will be qualifying or nonqualifying depending upon its character at the partnership or trust level. This approach was suggested by the Blue Book, which states (at page 382):

> "[T]he Congress did not intend that a RIC's distributive share of income from a partnership interest would be treated as qualifying income derived with respect to the RIC's business of investing in securities without regard to the character of the income derived from the partnership." (Footnote omitted.)

The Blue Book observed that a technical correction might be needed to reflect this intent.

In order to reflect this intent, we recommend that in lieu of the amendment contained in the Technical Corrections Bill, Section 851(b) should be amended by adding at the end thereof the following new sentence:

> "For purposes of paragraph (2), the corporation's distributive share of any partnership income and any amounts distributed to the corporation by a trust shall not constitute qualifying income unless the gross income of the partnership or trust to which such distributive share or amounts are attributable would be qualifying income if accrued or received directly by the corporation."

V. Exemption From Section 851(b)(3) For RICs In Liquidation

As noted above, one of the requirements for Subchapter M treatment is that a RIC derive less than 30% of its gross income from the sale of stock or securities held for less than three months. Code Section 851(b)(3). Real estate investment trusts ("REITs"), which are also covered by Subchapter M, have a similar restriction that limits the portion of the gross income that can be derived from certain sources, including gains from the sale or other disposition of stock or securities held for less than six months. See Code Section 856(c)(4)(A). The provisions of Subchapter M relating to REITs were modeled after the RIC provisions, and the tax treatment of these two types of entities is generally similar.

The Technical Corrections Bill includes an amendment providing that for purposes of the REIT "short-short test" the REIT does not take into account any gain from the sale, exchange or distribution of property once it adopts a plan of complete liquidation. See Joint Committee Description at 57. This provision is presumably included because of a recognition by Congress that once a REIT has adopted a plan of liquidation, it will need to dispose of its assets in an orderly way and that doing so might cause the REIT to run afoul of the REIT short-short test. In addition, during the liquidation process there is no compelling policy reason for applying all of the qualification requirements that are intended to govern REITs as ongoing entities.

All of these considerations equally support a similar rule in the case of RICs, and we are aware of no reason why the same treatment should not apply in the case of a RIC liquidation. Accordingly, we recommend that the Technical Corrections Bill be amended to include a provision adding the following sentence at the end of Section 851(b):

> "For purposes of paragraph 3, there shall not be taken into account in the taxable year in which the corporation is completely liquidated any gain from the sale, exchange or distribution of any property after the adoption of the plan of complete liquidation."

Section 614

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July 24, 1987

Extraordinary Dividends: Comments on Section 106(c)(3) of the Technical Corrections Bill of 1987

We would like to propose a revision to Section 106(c) of the Technical Corrections Bill of 1987, which revises Section 1059(d)(7) of the Internal Revenue Code of 1986 and redesignates it as Section 1059(d)(6). The discussion below focuses on revised Section 1059(d)(6) as contained in the Technical Corrections Bill.

Section 1059(d)(6), which contains a special exception to the general rule of Section 1059, provides that no basis reduction is required in the case of an otherwise extraordinary dividend received with respect to stock if: (a) the taxpayer has held the stock during the entire period such corporation was in existence, and (b) the earnings and profits from which the dividend is paid could not have been attributable to any person other than the original shareholder receiving the distribution. As a result, Section 1059(d)(6) relief is limited to the narrow class of equity investors who are committed to, and bear the risk of, a corporation's business from its inception. Unfortunately, if Section 1059(d)(6) is applied literally, Section 1059(d)(6) relief would not be available in most situations for which it was intended.

Four examples of very common situations will illustrate this point. In the first example, a shareholder purchases preferred stock a few days after the corporation is formed and the common stock is issued to the common stock shareholder. In the second example a shareholder purchases the stock of a shelf corporation that had been formed some months previously. In the third example, a shareholder purchases preferred stock of a corporation that for some time had been an inactive member of a consolidated group. In the fourth example, a shareholder purchases the stock during the time in which the corporation is engaging in such preliminary activities as negotiating contracts, securing suppliers and customers and sources of funding but prior to the time in which it is capable of engaging in the business activities for which the corporation has been formed.

This fourth example is very common since the various participants in a venture, e.g., debt, equity, suppliers, contractors and customers, often will not commit themselves unless all the other parties are simultaneously committed. Such ventures are typically put together in a series of more or less simultaneous closings which take place after weeks or months of negotiations.

For example, our client is in the business of building and operating large cogeneration facilities. Each cogeneration facility is constructed and owned by a separate corporation ("Subsidiary") established solely for this purpose. Typically our client spends many weeks or months locating the project, negotiating for the acquisition of the land, negotiating the fuel supply contract, power supply agreements and construction agreements, and securing sources of funding. All of these different elements are brought together at a series of more or less simultaneous closings in which the various agreements are signed and the debt and equity players agree to funding levels. Although all these preliminary activities are carried out on behalf of the Subsidiary, the Subsidiary is not really in a position to begin conducting business until such closings. If the negotiations with any of the parties fall through prior to closing and a substitute party cannot be found, the project must typically be abandoned or restructured.

We submit that equity investors who either acquire stock on or before such closing, or who enter a binding contract on or before such closing to acquire stock, should be treated for purposes of Section 1059(d)(6) as if they held such stock for the entire existence of the corporation and should be accorded relief under Section 1059(d)(6). We would include within this rule equity investors who have entered into a binding contract to acquire stock since such investors are committed to, and bear the risk of, the venture for the requisite period. In this context, such a binding commitment carries with it the requisite incidents of stock ownership. There should be no policy reason why such investors should not be afforded relief under this provision merely because the venture was able to rely on their commitment and did not require them to immediately fund their commitment with capital.

We would propose handling this issue by inserting language along the following lines in the committee report discussion of proposed Section 1059(d)(6):

> "For purposes of this provision, a shareholder will be treated as holding stock on the first day of a corporation's existence if such shareholder acquires the stock prior to the time the corporation engages in any significant business activity other than preliminary activities. Preliminary activities are those incident to the start-up of business operations, such as soliciting and securing customers and suppliers; negotiating and concluding contracts which are necessary or useful for the business; securing sources of funding and necessary permits or approvals; interviewing and hiring employees; and securing office space or other facilities. The corporation will not be deemed to be engaged in preliminary activities once it is in a position to commence the business activities for which it has been formed. A taxpayer will be deemed to hold stock in the corporation for purposes of this provision beginning on the date on which he enters into a contract which is binding on such taxpayer to purchase such stock."

William G. Cavanagh

Section 621

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

LAWRENCE J. WHITE
BOARD MEMBER

July 16, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Re: Technical Corrections Act of 1987 (H.R. 2636)

Dear Mr. Leonard:

On behalf of the Federal Home Loan Bank Board ("Bank Board") and the Federal Savings and Loan Insurance Corporation ("FSLIC"), we propose several additional technical corrections to new Code section 382 (relating to limitations on net operating loss carryovers and other tax attributes following a corporate reorganization) as enacted by the Tax Reform Act of 1986. Our proposals supplement the helpful corrections already included in H.R. 2636, as introduced.

The Bank Board and the FSLIC, as the federal deposit insurance arm of the Bank Board, are governmental agencies responsible for regulating the savings and loan industry and protecting the interests of depositors. As you know, the entire financial services industry is undergoing significant change in terms of the scope of powers and authorities of thrift institutions and commercial banks and in terms of financial problems that sectors of the industry are undergoing at the present time. Although the thrift industry as a whole is healthy and profitable, a sizable fraction of the industry continues to undergo financial stress stemming from a collection of circumstances, including high interest rates during the early 1980s (which produced a mismatch between income and the cost of funds) and, more recently, from severe asset quality problems.

In our role as federal regulators, the Bank Board's responsibility includes protecting the safety and soundness of thrift institutions and, in particular, the interests of depositors whose confidence is vital to financial institutions of all kinds throughout the country. The FSLIC payments that have been necessary to protect depositors in insolvent institutions have led to the current insolvency of the FSLIC insurance fund. Legislation is currently under consideration in the Congress to recapitalize the FSLIC insurance fund and enable us to continue to meet our statutory obligations.

One of the important ways the Bank Board and the FSLIC protect the interests of depositors in thrift institutions is to assist in merging financially-troubled institutions into healthy institutions that agree to assume the assets and deposits of a failed institution. The FSLIC is empowered to provide financial assistance, where appropriate, in these acquisitions. Federal banking law requires that any such assistance must be less than the cost of liquidating an insolvent institution and paying out insurance funds to its depositors. This criterion has helped assure that the FSLIC insurance fund will be conserved to the greatest extent possible.

In this area of supervisory mergers and FSLIC financial assistance, Congress enacted a series of tax provisions in 1981 that have proven invaluable to the FSLIC in arranging FSLIC-assisted mergers. One of the key provisions specifies rules under which a FSLIC-assisted merger of a defaulted thrift institution into an acquiring entity can qualify for tax-free reorganization treatment (Code section 368(a)(3)(d)(ii)). Another provision preserves the tax history of the defaulted institution (Code section 382(b)(7)(B)). Still another provision renders FSLIC financial assistance not subject to taxation (Code section 597). These tax provisions are a cornerstone of our merger program and are essential to our continued ability to supervise the troubled portions of the industry and find merger partners to reduce the strain on the FSLIC insurance fund. Through hard bargaining on the part of the FSLIC, we are able to recapture for the FSLIC the tax advantages that in the first instance appear to accrue to the acquiring party. Thus, these tax provisions are an important aid to the FSLIC in allowing us to stretch our very limited resources farther and thus to deal with a larger number of troubled thrift institutions.

In the Tax Reform Act of 1986 ("1986 Act"), Congress decided to continue the entire group of tax provisions dealing specifically with FSLIC transactions but to subject them to review at the end of 1988. The 1986 Act thus "sunsets" the FSLIC provisions at the end of 1988, thereby enabling Congress to review the continued need for the provisions beyond that period. However, we have identified several items that need technical correction, particularly in connection with the revision of new Code section 382. As introduced by Chairman Rostenkowski, H.R. 2636, makes several needed changes. These are described in the attachment to this letter, and we appreciate their inclusion in the bill. There are, however, three additional items, discussed in more detail in the attachment, that we propose for inclusion in the bill. These items deal with the preservation of a rule of prior law benefitting tax attributes in FSLIC mergers, which seems to have been omitted inadvertently in the 1986 Act; the prevention of the application of a new provision in new Code section 382 that will hinder the preservation of prior law for FSLIC transactions; and the inclusion, within the scope of a special two-year "window" for mutual-to-stock thrift conversions, of certain formalistic mechanics for accomplishing a conversion that apparently were not focused on when new Code section 382 was drafted.

We regard each of these items as wholly technical in nature. Their correction is entirely within the scope of the policy decisions made by Congress. They contain no hidden effects or changes for FSLIC transactions, and we believe that they pose no problem with respect to the harmonization of the treatment of those items alongside the unaffected provisions of the 1986 Act. Each item, however, has important practical effects for real life transactions that we supervise and are important to the agency. For example, the first item mentioned -- the problems that arise with respect to the 20% deposit continuity ratio -- has delayed and distorted the completion of mergers in several transactions. (Data on these cases are summarized in item A-1 of the attachment.)

We would also like to note that the Bank Board and the FSLIC are still in the process of assessing the impact of the 1986 Act on the agency. It is our sincere hope that the Committee will be receptive to additional technical corrections if the need should arise.

We respectfully request that the items described in the attachment be included in the Technical Corrections Act of 1987.

Respectfully submitted,

Lawrence J White

Lawrence J. White
Board Member

Attachment

ATTACHMENT

Technical Corrections Needed
To Section 382, as Amended
by the Tax Reform Act of 1986
(sec. 621), for Thrift Transactions

The following items relate to Code sec. 382 (relating to limitations on net operating loss carryovers) as revised by the Tax Reform Act of 1986.

A. SUPERVISORY MERGERS AND CONVERSIONS

1. 20% deposit continuity test for NOL carryovers.

Under prior law, in a supervisory merger of a failed thrift, net operating loss (NOL) carryovers were fully preserved if the acquired thrift's deposits comprised at least one-fifth (20%) of the combined deposits of the combined institution after the merger. If this level was not attained, the carryovers were "scaled down" by 5% for each 1 percentage point below 20% represented by the transferred deposits. (Former sec. 382 (b)(7)(B)). This provision treated thrift deposits as stock for purposes of qualifying under the general rule of prior sec. 382(b). That general rule, applying to all reorganizations, preserved the full dollar amount of NOL carryovers if "shareholders" of the loss company received stock worth 20% or more of the value of all the stock of the combined company. If the 20% level was not attained, the scaledown formula applied, that is, the carryover dollar amount was reduced by 5% for each 1 percentage point below the 20% level.

In the Tax Reform Act of 1986, Congress decided to continue, at least through the end of 1988, the prior law relating to FSLIC-supervised acquisitions. This policy meant preserving the special qualifying reorganization rules in sec. 368(a)(3)(D)(ii), the tax attribute rules of sec. 382, and the treatment of FSLIC assistance payments in sec. 597. Neither the Conference Report nor the "Bluebook" prepared by the staff of the Joint Committee on Taxation expresses any intent to alter the FSLIC tax provisions in any substantive way.1/

The statute itself, however, does not contain the graduated scaledown of tax attributes where the 20% deposit proportion is not attained in a FSLIC-supervised acquisition. As a result, the NOL carryovers would be severely limited in those cases after the merger. The annual limitation on utilizing the defaulted thrift's tax attributes would come into play, creating a large "cliff" depending on whether the 20% proportion is met or missed, even barely. This inadvertent omission in the statute creates undesirable difficulties for the Bank Board and the FSLIC. On one hand, it tends to discourage the very type of acquisition which FSLIC encourages, namely, very large acquirers agreeing to rescue smaller institutions. Larger acquirers offer better prospects of rehabilitating a troubled institution. On the other hand, if the tax rules compel the FSLIC to locate acquirers which are not so big as to trigger the "cliff" --

---

1/ See General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation, 571 (May 4, 1987).

because the 20% deposit ratio will not be attained -- the Bank Board has regulatory concerns over the safety and soundness of the acquisition. The tax rules should not place the federal regulator in such a difficult position.

In a sample of eleven FSLIC-assisted mergers completed in 1986 and 1987, six of the mergers did not meet the 20% ratio. If these six mergers were subject to the statute as it now reads, the NOL carryovers would be lost as a result of the "cliff" and FSLIC would not receive any related benefit. Furthermore, in one of the five mergers that did meet the 20% ratio the asset mix was intentionally rearranged in order to preserve $200 million in NOL carryovers. In addition, a primary reason a pending merger has been delayed is to consider ways to rearrange the deposit ratio in an attempt to preserve $110 million in NOL carryovers.

The scaledown rule of prior law was not ambiguous or difficult to apply. It was part of the prior tax rules which applied to assisted thrift mergers and should be restored to current law, as Congress intended.

2. Possible complete extinguishment of NOL carryovers where FSLIC creates an "interim" association

Under the 1986 Act, a second reorganization occurring within two years after a first reorganization extinguishes NOL carryovers in toto for years following the second reorganization (sec. 382(l)(5)(D)).2/

This provision could totally eliminate NOL carryovers in a FSLIC-supervised acquisition of an insolvent thrift where the thrift's assets are first conveyed to an "interim" savings and loan association created and operated by the FSLIC while a buyer is sought, and then a buyer acquires control of the interim association. In private tax rulings IRS has treated these steps under prior law as two successive type (G) reorganizations. See PLR 8411060 (Dec. 14, 1983). This two-step format would not have had any adverse effect on NOL carryovers under prior law, because no penalty arose based on a short time period between successive reorganizations.

The two-step format in FSLIC transactions where an interim thrift association is created is not part of any arrangement involving potential abuse. The two-year rule in new sec. 382 appears to have been developed in order to prevent creditors of a bankrupt regular corporation from becoming shareholders of the corporation, preserving NOL carryovers for their ultimate benefit, but thereafter selling off their stock to third parties who are strangers to the company and whose money did not finance the operating losses. FSLIC transactions are altogether different. An interim thrift association is created by the FSLIC in receivership situations where it is essential to protect depositors in the defaulted institution and quickly remove assets and liabilities to a more secure corporate entity.

2/ This provision in "new" sec. 382 reads as follows:

> "Section 382 Limitation Zero if Another Change Within 2 Years. -- If, during the 2-year period immediately following an ownership change to which this paragraph applies, an ownership change of the new loss corporation occurs, this paragraph shall not apply and the section 382 limitation with respect to the 2nd ownership change for any post-change year ending after the change date of the 2nd ownership change shall be zero."

To achieve this objective, if an ultimate buyer for the institution has not been located at the time the failed thrift is placed in receivership, the FSLIC may create a newly chartered Federal mutual savings and loan association to receive assets and deposit liabilities, and to operate thereafter with new management, until an ultimate purchaser can be found. The selection of a purchaser may itself involve a period of time consisting of an invitation for proposals from interested potential purchasers and, after acceptance of a particular proposal, negotiation of an assistance agreement with the FSLIC. In substance, the creation of the interim mutual association is a holding action and the purchaser's acquisition of the interim association is the true acquisition.

Therefore, the Board believes that the two-year provision of new section 832(l)(5)(D) was not intended to apply to, and ought not apply to, a FSLIC-supervised acquisition that may involve a "holding" entity. Such a two-year rule was not a part of prior law and should not now be imposed as a new obstacle in view of Congress' policy to continue the prior law as it applied to FSLIC transactions.

In accord with Congress' policy to maintain prior law through 1988, the two parts of a supervisory acquisition should not cause any loss of tax attributes.

B. PUBLIC OFFERINGS OF STOCK IN A THRIFT CONVERTING FROM MUTUAL TO STOCK FORM

Sec. 621(F)(4) of the Tax Reform Act of 1986 effectively prevents the new limitations on NOL carryovers from applying to public offerings of stock in a savings and loan association which is converting from mutual to stock form during 1987 and 1988. The transition rule exempts from the definition of an equity structure shift in new sec. 382 a public offering "with respect to domestic building and loan transactions * * *." This "window" clearly applies to a mutual thrift issuing its stock directly to the public.

Three other mechanical ways to convert a thrift from mutual stock form should also be covered under the special two-year "window":

> (1) A "merger conversion," where a mutual S&L or savings bank merges into a newly-created or existing S&L, and a public offering is made of stock in the acquiring association; and
>
> (2) A "holding company conversion," where a holding company purchases all the conversion stock and makes a public offering of stock of the holding company.
>
> (3) A "holding company conversion" where the mutual merges into a newly-created or existing S&L which is a subsidiary of a savings and loan holding company, and the public offering is made of stock of the holding company (rather than of the subsidiary itself).

The IRS has issued numerous private letter rulings approving all three types of conversions as taxfree reorganizations. However, under the new NOL carryover restrictions the first and third formats would technically be classified as equity structure shifts, which in turn will cause NOL carryovers to be limited under the new general rule, i.e. only a small percentage of the NOL carryover can be utilized each year.3/ It is unclear, as the Board reads the language of Section 621(f)(4) of the Tax Reform Act, whether the phrase "domestic building and loan transactions" extends to a conversion by merger with a different corporate entity and a public offering of stock in the acquiring entity or in a holding company which is the parent of the acquiring entity.

If a holding company buys the conversion stock and then sells stock in the holding company (Situation (2)), it is also unclear whether the public offering is a "domestic building and loan transaction" within the meaning of the two-year window.

The mechanical form of accomplishing a mutual-to-stock conversion should not be significant. Allowing form to prevail over substance will inhibit the FSLIC's capital-raising goal to forestall defaults and attract private capital into the thrift industry. The conversion formats described above should be equally protected under the two-year exemption in Sec. 621(f)(4) of the Tax Reform Act for thrift conversions during 1987 and 1988.

A revision of the language of Sec. 621(f)(4) of the Tax Reform Act, as proposed in H.R. 2636, also seems uncertain with respect to covering the conversion mechanics described above. The bill (sec. 106(d)(15)) would substitute a reference to "institutions described in section 591 of such Code with respect to any public offering before January 1, 1989." This language seems literally inapplicable to a public offering of stock in a holding company which is not itself a thrift institution. The language is also ambiguous with regard to whether it refers only to a public offering of stock in the mutual entity itself, or also to a public offering of stock in an entity which acquires assets of the converting institution by means of a statutory merger.

C. ITEMS ALREADY INCLUDED IN THE TECHNICAL CORRECTIONS BILL AS INTRODUCED

The Board and the FSLIC welcome the items referred to below which are included in H.R. 2636, as introduced.

1. Deposit test.

For purposes of the survival of NOL carryovers, the 20% deposit proportion test will be calculated solely by reference to the value of the deposits and not by requiring savings deposits to possess voting power. Section 106(d)(8)(A), Technical Corrections bill.

2. Firm commitment underwriting.

A firm commitment underwriting in connection with a public offering of stock in a converting mutual savings and loan association is protected against reduction in NOL carryovers under the two-year "window" for thrift public offerings during 1987-88. Sec. 106(d)(15), Technical Corrections Bill.

3. Inclusion of savings banks.

Savings banks, in addition to savings and loan associations, are included in the two-year "window" for NOL carryovers in thrift public offerings during 1987-88. Sec. 106(d)(15), Technical Corrections Bill.

3/ The general rule of sec. 382 would govern because, under the rules, investors in the public offering would be viewed as causing a greater-than-50% change in the ownership of the converting mutual association. This result would occur pursuant to new sec. 382(g) (4) (B) (i), which in the case of a merger involving two distinct corporations, segregates the shareholders of each separate company in calculating whether an ownership change has occurred.

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July 16, 1987

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Re: Comments Regarding Regulations
Under Code Section 382

Dear Mr. Wessel:

As I mentioned on the telephone yesterday, I understand that serious consideration is being given by the Treasury Department to adopting regulations which would determine whether an "ownership change" has occurred for purposes of section 382 of the Internal Revenue Code of 1986 by comparing stock ownership immediately after an owner shift or equity structure shift with the lowest percentage of stock held by each 5 percent shareholder during the testing period, even if there has not been a cumulative change in ownership of more than 50%. I believe this to be contrary to the intended meaning of the statute and request that you reconsider this issue.

Section 382(g)(1) defines an ownership change by comparing (A) the percentage of stock owned by 5-percent shareholders immediately after an owner shift or equity structure shift with (B) "the lowest percentage of stock of the old loss corporation...owned by such shareholders at any time during the testing period." If the former percentage is more than 50 percentage points greater than the latter percentage, there is an ownership change. The regulation being considered by the Treasury Department apparently would measure the latter percentage by adding together the lowest percentages of stock held by 5-percent shareholders during the testing period, even if the lowest percentages for particular shareholders occurred on different dates. The reference in Code section 382(g)(1)(B) to "percentage," in the singular, suggests that, as in the case of the percentage referred to in clause (A), the percentage is to be determined at one time, rather than by adding the lowest percentages of the 5-percent shareholders occurring at different times.

The alternative interpretation would lead to anomalous results. Consider, for example, the following situation. All of the stock of L corporation has been owned since its inception by A and the public (i.e., shareholders who are not 5-percent shareholders), 20% by A and 80% by the public. If B buys 20% of the L stock from the public on January 1, 1989 (reducing its percentage to 60%) and 20% of the L stock from A on January 2, 1989, there will be no ownership change since B has increased his ownership by only 40%. A different route for B to end up with 40% of the L stock and for the public to end up with 60% would be for B to purchase 40% of the L stock from the public on January 1, 1989 and for A to sell 20% of the L stock to the public on January 2, 1989. Under the regulation being considered by the Treasury Department, there apparently would be an ownership change under this second route, because the public's ownership of L stock will have gone from 40% (its percentage the day before January 2, 1989) to 60% and B's ownership will have gone from 0% (his percentage before January 1, 1989) to 40%.

This potential trap for the unwary should be eliminated by interpreting the phrase "owned...at any time" in Section 382(g)(1)(B) as "owned...at any one time" rather than "owned...at one or more times." Under this interpretation there would not be an ownership change in the above example, whether B used the first route or the second route to acquire 40% of the L stock, because the measuring date would be either the day before January 1 or January 2 (or any other time during the testing period) but not both days. I am sending the appropriate number of copies of this letter to the Chief Counsel of the Ways and Means Committee of the House of Representatives, and, in the event that the Treasury Department does not concur with this interpretation of Code section 382(g)(1)(B), I would request that a clarification of Congressional intent be considered for inclusion in the Technical Corrections Act.

Sincerely,

Micah W. Bloomfield

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TECHNICAL CORRECTIONS BILL OF 1987

COMMENTS REGARDING SECTION 106(d) OF THE BILL

(Section 621 of the Tax Reform Act of 1986; Section 382 of the Internal Revenue Code of 1986)

Our attempt to apply Section 382 of the Internal Revenue Code of 1986 (the "Code") to several contemplated transactions has revealed a number of ambiguities which we believe could usefully be addressed in connection with Section 106(d) of the Technical Corrections Bill of 1987 (the "Bill"). Certain of these points may be suitable for inclusion in regulations to be issued under Section 382, and therefore could either be addressed in the Committee Report which will ultimately accompany the Bill or in specific statutory directives to the Treasury to be included in the Bill. Our particular concern is with the rules regarding the aggregation of less than five percent shareholders, and the pooling of such shareholders into one or more groups (Sections 382(g) and (m)). Statutory ambiguities arise in the following situation. A large, publicly traded corporation (the "Company") issued convertible debentures in a public offering after May 6, 1986. No purchaser of the debentures currently holds sufficient debentures such that upon conversion he would hold stock representing five percent or more of the value of the outstanding stock of the Company. The issuance of the debentures, although occurring within the testing period for the application of new Section 382, was not itself of sufficient magnitude to cause an ownership change. However, the Company now anticipates that certain other transactions will be undertaken, the effect of which under Code Section 382 is dependent upon the treatment of the issue of the debentures under that Section. Further, since the Company is publicly traded on an active basis, it is quite possible that acquisitions of the Company's stock which are beyond its control could, when taking into account the debentures, cause an ownership change.

Section 382(l)(3)(A)(iv) provides that Section 318(a)(4), the attribution rule which treats persons who own options as if they own the underlying stock, shall be applied for purposes of Section 382 if to do so would result in an ownership change. A similar rule is to apply to convertible debt. It is clear that after any equity structure shift or owner shift affecting a five percent shareholder the test for whether an ownership change has occurred must be performed by assuming that the debentures are converted. The critical issue in the case of the Company is whether in so doing all the debenture holders are to be added to the existing group of less than five percent shareholders, or whether they must be separately aggregated and treated as another, separate, shareholder that owns more than five percent of the stock of the Company. The resolution of this question is ambiguous under the terms of the statute.

Paragraph (g)(4)(A) states the general rule that all less than five percent shareholders are to be aggregated and treated as a single shareholder. This rule is modified by paragraph (g)(4)(B), which provides that in determining whether an equity structure shift is an ownership change, the group of less than five percent shareholders of each corporation which was a party to the reorganization constituting the equity structure shift shall be separately aggregated. Although the issuance of the debentures was not by definition an equity structure shift, there are several ways in which this segregation rule could potentially be applied to require the separate aggregation of the debenture holders.

First, paragraph (g)(3)(B) provides that "to the extent provided in regulations", the term "equity structure shift" shall include ". . . public offerings and similar transactions." The General Explanation of the Tax Reform Act of 1986 (the "General Explanation") indicates that such regulations, at least in so far as they relate to public offerings, will be prospective. The Conference Report contains similar language. The Company issued the debentures in a public offering. It is not clear from the statute, however, how the paragraph (g)(3)(B) regulations would apply to this example. Assume for example that after the effective date of the prospective regulations, the Company undertakes a transaction which constitutes an equity structure shift or an owner shift. Assume further that, if upon the hypothetical conversion of the debentures pursuant to Section 382(l)(3)(A)(iv) the debenture holders were treated as a separate single shareholder rather than being aggregated with the existing less than five percent shareholders, an ownership change would occur. There would not be an ownership change if the debenture holders were not separately aggregated. Although the issuance of the debentures occurred before the effective date of the prospective regulation treating the public offering of the debentures as an equity structure shift, the hypothetical conversion occurred after that date.

It would seem appropriate that the date of issue of the debentures should be the relevant point for determining whether the prospective regulations apply in this example. Under Treasury Regulation 1.382(a)-1(a)(2), issued under old Section 382, stock acquired by exercising an option is considered to have been acquired on the date the option was acquired. Nothing in the new statute suggests that this rule should not continue to apply. Since under new Section 382(l)(3)(A)(iv) the stock underlying an option or other interest such as convertible debt may be considered in determining the existence of an ownership change at any time on or after the date the interest is acquired, it would seem consistent and logical for this rule to continue. If the date of the hypothetical conversion of the debentures (that is, the date of a subsequent equity structure shift or owner shift) were the relevant date for determining whether prospective regulations treating public offerings as equity structure shifts apply, rather than the date of issue, then anomalous results could occur. The mere existence of convertible debentures or stock options issued by a public company in, say, early 1985, long before the terms of new Section 382 became known, could give rise to an ownership change if another event to which the new regulations have no relevance occurred, such as the acquisition of more than five percent of the company's stock by an unrelated third party.

A similar issue arises outside the context of subsection (g)(3)(B). Paragraph (g)(4)(C) states that, except as may be provided in regulations, the rules for segregating groups of less than five percent shareholders described above apply to owner shifts involving five percent shareholders. Both the General Explanation and the explanation accompanying the Technical Corrections Act of 1987 make clear that this rule as drafted applies only to transactions in which more than one corporation is involved, like those described in section (g)(3)(B)(i). This rule would not itself require the segregation of the debenture holders. However, Section 382(m)(5) states that regulations will provide for the application of subsection (g)(4) where only one corporation is involved. Taken together, these two provisions could result in the segregation of the debenture holders as a single shareholder, even without the treatment of the debenture offering as an equity structure shift under paragraph (g)(3)(B). Unless the (m)(5) regulations are made prospective with respect to these transactions, the same anomalous results described above would occur, thus vitiating the prospective nature of the Section 382(g)(3)(B) regulations. We therefore suggest that the (m)(5) regulations as applied to convertible debentures and similar instruments be prospective, with the relevant date for determining their applicability the date of issuance of the instrument. This is appropriate since the General Explanation and, particularly, the Conference Report appear to provide that any regulations permitting the segregation of less than five percent shareholders in the context of public offerings are to be prospective in nature. See General Explanation p. 306; Conference Report p. 176.

Thank you very much for your consideration of these points. We are, of course, available to discuss these matters further should you wish to speak with us.

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*ADMITTED IN FLORIDA ONLY

July 16, 1987

TREATMENT OF OPTIONS AND WARRANTS UNDER SECTION 382 OF THE INTERNAL REVENUE CODE

DISCUSSION

We are pleased to provide the following comments regarding Section 382 of the Internal Revenue Code of 1986 and the proposed amendments by the Technical Corrections Act of 1987. We believe these comments are consistent with the goal of Section 382, to limit the carryover of tax losses following a change in the ultimate beneficial ownership of the corporation during the testing period, and thereby eliminate "trafficking" in tax losses.

Our comments relate to the treatment of warrants and options which occurred in the following situation. In July 1986, our client, a domestic corporation (Acquiring) purchased 25% of the stock of an unrelated domestic corporation (Target 1) from its owner (O), and received from Target 1 warrants to purchase unissued Target 1 stock. At that time, Target 1 had significant net operating loss carryforwards. Due to the uncertain value of Target 1 as of the acquisition date, the exercise price of the warrants was determined by a formula based on the net capital of Target 1, without regard to its net operating loss carryforwards.

Acquiring assigned 20% of its then 25% Target 1 stock interest and 20% of the Target 1 warrants to two unrelated business organizations (A and B). By December 1986, Acquiring's accountants had determined that the net capital of Target 1 was such that the exercise price of the warrants would be zero. In December 1986, Acquiring purchased the remaining 75% of the stock of Target 1 from O and simultaneously granted A and B an option to acquire 20% of that 75% interest. Since the exercise price of the warrants to acquire Target 1 stock equaled zero, exercise of the warrants was a mere formality. On January 31, 1987, the exercise of the warrants was completed for no cost and additional Target 1 stock was issued to A and B. Shortly thereafter A and B exercised their option to purchase 20% of Acquiring's 75% interest as well and became full 20% shareholders in Target 1.

In February 1987, Target 1 granted an option to a domestic corporation (C) to acquire unissued stock of Target 1 sufficient to give C a 20% interest in Target 1. In March 1987, Target 1 began negotiations to acquire all of the outstanding stock of a domestic corporation (Target 2) in exchange for a combination of cash and Target 1 stock.

The Target 2 acquisition can only be accomplished if a significant amount of the equity of Target 1 can be offered to Target 2 shareholders and to persons who will provide the cash necessary to buy out the remaining Target 2 shareholders. In order to determine the amount of Target 1 equity that is available for the Target 2 acquisition without triggering a change of ownership of Target 1 under Section 382, several questions have arisen regarding the proper treatment of the warrants and options granted to A, B and C to acquire Target 1 stock. The most important of these questions lies in the determination of the "base line" ownership of Target 1 in December 1986 to enable Target 1 to decide what will constitute a 50% increase in the ownership of its shareholders under Section 382. Are A and B's no cost warrants which were converted to stock in early 1987 considered stock equivalents for purposes of determining their percentage ownership in December 1986? What about the options granted by Acquiring in favor of A and B in December 1986 which were also later exercised? Does the option given to C on unissued stock of Target 1 contribute to a potential change of ownership, or should the rules of Section 318 apply to require that these options be disregarded until exercised?

1. The General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation (p. 311, fn. 32) states that, "[i]t is expected that the Treasury Department may consider whether there are circumstances in which it may be appropriate to limit the operation of [the deemed option exercise] rule to transactions occurring during any three-year testing period that includes the date the option or other interest is issued or transferred." We request that the committee reports for the Technical Corrections Act of 1987 clarify that Congress expects the Treasury Department to consider as exercised from the date of issuance options, warrants or similar rights issued before the beginning of the testing period that have a zero exercise price as of the beginning of the testing period and that are not transferred during the testing period. Moreover, if the warrant or option ultimately is exercised during the testing period, the warrant or option should be treated as exercised as of the beginning of the testing period.

The conversion of a no cost warrant or option to a share is a mere formality without economic effect, and thus should be treated as such. The purpose of Section 382, to limit the carryforward of net operating losses following an ownership change during the testing period, would be thwarted if the exercise (deemed or actual) of the no cost warrant or option were treated as an increase in ownership. The no cost warrant or option holder was in economic reality an owner of the corporation as of the beginning of the testing period and should be so treated.

The effect of this clarification on the acquisition of Target 2 by Target 1 would be to make more certain the base line ownership percentages against which later changes could be measured. It is noteworthy that if the impact of Section 382 had been understood fully prior to the end of 1986, A and B clearly would have exercised the no cost warrants at that time in order to increase their base line ownership.

2. Section 382(l)(3)(A)(iv) generally provides for the deemed exercise of warrants and options if an ownership change would result. The General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation (at p. 311, fn. 32) indicates that, if an option is deemed exercised, the shareholder will be treated as owning the stock on and after the date on which the option is acquired or is later transferred. It is not clear which is intended, that the deemed exercise of an option relate back to the date of acquisition by the option holder, or that the option is deemed exercised only at the instant that a change of ownership would occur. We believe that the first interpretation is correct as a matter of economic substance, consistency and sound tax policy. In addition, it must follow that if the deemed exercise of an option relates back to the acquisition date of the option, the actual exercise of an option also must relate back to the acquisition date.

The deemed exercise of an option rule recognizes that, in most cases, an option on stock and a share of stock are economically indistinguishable.[1] Consistency requires that an option treated as an ownership interest be treated as such from the date of acquisition. There is no justification for limiting the deemed exercise of an option to a moment in time based on changes in ownership interests among other shareholders. We recognize that in certain instances, options may be issued which were never intended to be exercised in order to circumvent the Section 382 limitations. We suggest that the proper method for dealing with such abuse would be to ignore options that do not qualify as such in economic substance.

Further, the relation of the deemed exercise of an option back to the date of acquisition of the option is analogous to the provision under Section 382 that allows the loss corporation to file amended tax returns for prior years if an option expires without being exercised, but the existence of the option resulted in an ownership change and net operating loss carryforward disallowance. If the expiration of an option is treated as relating back to correct mistaken assumptions about the substance of an ownership interest in the corporation, the same rule should apply to a deemed exercise of an option.

Finally, a deemed exercise rule that is limited to the instant when a change of ownership would result effectively extends the testing period beyond the statutory boundaries. An option issued with a ten year term could contribute to an ownership change at any time during its ten year life, spanning four (and possibly five) three year testing periods. The policy underlying the limitation on the carryforward of net operating losses has always recognized the need to limit the time period for measuring changes in ownership. Section 382 as amended by the Tax Reform Act of 1986 extended the time period to three years. The Technical Corrections Act of 1987 should clarify that an exception to the three year testing period was not intended in the case of options.

Assuming that the deemed exercise of an option acquired before the testing period relates back to the acquisition date (and thus does not cause an increase in percentage ownership), then the actual exercise of the option also should relate back to the acquisition date. The alternative conclusion, that the actual exercise of an option does not relate back, is illogical. The deemed exercise of an option assumes the economic substance of the ownership interest represented by the option. If the assumption of economic substance relates back in the case of a deemed exercise of an option, then the same result must apply where the economic substance is proven by the actual exercise of the option.

The effect of the relation back rule to the factual situation described above would result in an increase in the percentage ownership of Target 1 by A and B as of the base period date. Thus, following the exercise of the options and warrants acquired in 1986, A and B would experience a smaller increase in percentage ownership from the base period date to the date of exercise. This would allow Target 1 to use more of its equity to acquire Target 2 without causing a change of ownership.

1/ A share of stock is economically equivalent to an option. Black F., M. Scholes "The Pricing of Options and Corporate Liabilities" Journal of Political Economy, May/June 1973, pp. 637-659. A share of stock represents the right to the liquidation value of a corporation after payments due to creditors. The exercise price of this "option" is zero and the strike price is the amount owed to creditors. Since an option on stock grants the holder and option to become a shareholder, it is merely an option on an "option."

3. Section 382(l)(3)(A)(iv) as enacted by the Tax Reform Act of 1986 provided for the deemed exercise of options in accordance with Section 318(a)(4) (if an ownership change would result). As recognized by the Staff of the Joint Committee in its General Explanation of the Tax Reform Act of 1986 (at p. 311, fn. 33), case law supports the view that, in certain circumstances, options on unissued or treasury stock are disregarded under Section 318 (a)(4). In order to correct this apparent defect, the proposed Technical Corrections Act of 1987 amends Section 382(l)(3)(A)(iv) to eliminate the reference to Section 318(a)(4) and to treat all options to acquire stock as deemed exercised if a change of ownership would result. Although we do not oppose the amendment, we believe that the change is substantive and should be limited to options issued on or after the date of introduction of the Technical Corrections Act. We request clarification in the committee reports that options on unissued stock granted prior to the date of introduction would be ignored for purposes of Section 382(l)(3)(A)(iv).

The effect of this clarification on the acquisition of Target 2 would be to ignore the option granted to C and thereby increase the equity of Target 1 available for the acquisition of Target 2 without triggering a change of ownership. Although the proposed amendment may be appropriate, its retroactive application would unfairly upset transactions planned in reliance upon existing law.

Due to the likely delay in the issuance of regulations and the need for guidance to complete transactions, we respectfully request that resolution of these issues not be left to the Treasury Department's regulatory authority.

Dated: July 16, 1987

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July 17, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 2636--Technical Corrections Act of 1987--Sections 106(d)(2) and (15)--Net Operating Loss Carryovers

Dear Mr. Leonard:

We write you as counsel to Navistar International Corporation ("Navistar" or the "Company") to offer our comments on sections 106(d)(2) and (15) of the Technical Corrections Act of 1987 (the "Act"). These provisions, as you know, would amend the new net operating loss carryover rules enacted as section 382 of the Internal Revenue Code of 1986.

A. Factual Background

Navistar and its subsidiaries (formerly International Harvester Company) manufacture medium and heavy duty trucks, diesel engines and replacement parts. Navistar's principal offices are located in Chicago, Illinois. The Company is publicly owned and has in excess of 108,000 U.S. and foreign shareholders of record. Approximately 237 million shares of common stock and 22 million shares of preferred stock are outstanding. Approximately 25% of the Company's publicly-owned shares is held by financial institutions; large blocks of stock are held by brokers in street name.

During the period 1980-1985, Navistar experienced significant losses which severely weakened its financial condition. Net operating loss carryforwards attributable to this period remain unutilized.

Starting in 1981, Navistar undertook a number of financial restructuring transactions directed at improving its financial condition and ultimately reducing its debt. The most recent and significant step in this process occurred in December of 1986, when a public offering of 106 million shares of the Company's common stock was approved by the Company's shareholders, commenced and completed (the "Offering").[1] The Offering represented less than 50% of the total value of the Company's stock, and was effectuated through a firm commitment underwriting involving a syndicate of approximately 100 underwriters. Two of the underwriters were committed to acquire in excess of 5% of the total value of the Company's stock. Proceeds of the Offering were utilized to reduce the Company's outstanding indebtedness.

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[1] The Offering was approved on December 9, 1986. The registration statement filed with the Securities and Exchange Commission became effective on December 19, 1986, after which all of the stock was immediately sold. The Offering was closed December 29, 1986.

B. The Company's Concern

Navistar is concerned that, based on sections 106(d)(2) and (15) of the Act, as well as certain language contained in the General Explanation of the Tax Reform Act of 1986 prepared by the Joint Committee Staff (the "Blue Book"), the Offering might be considered as having given rise to a percentage increase in the stock ownership of the Company, and that such increase would be aggregated with stock ownership increases resulting from certain subsequent transactions so as to cause a more than 50% "ownership change" (under section 382(g)), thereby triggering application of the limitation on net operating loss carryforwards.

In particular, we are concerned about this possibility in the context of some future transaction that constitutes an "equity structure shift" within the meaning of section 382(g)(3), or that is deemed to constitute an owner shift, including, for example: (i) a tax-free reorganization in which Navistar acquires another company, and all or part of the consideration paid to the target company shareholders consists of Navistar stock; or (ii) another public offering of Navistar stock subsequent to the promulgation of the Treasury regulations authorized by section 382(g)(3)(B).

C. Outline of Position

The Company believes that any stock ownership percentage increase that resulted from the Offering should not be taken into account in determining whether any future transaction will trigger an "ownership change" under section 382(g). The principal points in support of this position are outlined below.

1. Legal basis for firm commitment/best efforts distinction is not readily apparent.

Aggregation of any stock ownership changes resulting from the Offering requires in the first instance distinguishing between "firm commitment" and "best efforts" underwritings -- a distinction which is not made by the existing statutory language. While the Conference Report to the Tax Reform Act of 1986 contains a footnote which recognizes this distinction to produce an "owner shift" in a more-than-50% public offering,[2] the footnote is based on a prior published ruling which interprets a different statutory provision and, if anything, supports obliteration of any such distinction.[3]

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[2] Conf. Rep., at p. II-178, n.7.

[3] The cited ruling, Rev. Rul. 78-294, 1978-2 C.B. 141, neutralizes the distinction in holding that the "control immediately after the exchange" requirement of section 351 was met in the context of situations involving both best efforts and firm commitment underwritings. If anything, it would seem that the policy reasons that support tax-free treatment in a section 351 transaction would require a more intensive examination of the firm commitment/best efforts distinction than in the section 382 context, where limits on the ability to utilize loss carryovers should depend on meaningful changes in ownership.

Moreover, as a practical matter, many firm commitment offerings involve only fleeting ownership by the underwriter of the issuer's shares, and it is not unusual for the bulk of the shares to be pre-sold prior to their acquisition by the underwriter. Nothing in the Conference Report purports to address the definitional problems that undoubtedly will arise in attempting to apply section 382 to firm commitment underwritings that involve these or other circumstances in which the underwriter in fact bears none of the economic benefits or risks of stock ownership.

2. Firm commitment underwritings should not affect "equity structure shift" calculations prior to public offering regulations.

Assuming, however, that the Conference Report "firm commitment" footnote is supportable as a matter of law, and that it could be applied to a less than 50% public offering, any resulting stock ownership percentage increase attributable to the underwriter's initial purchase of the offered shares (or to the ultimate sale of such stock to the public) should not be aggregated with later transactions which constitute "equity structure shifts". To permit aggregating such increases with a later equity structure shift would directly contravene the express mandate of section 382(g)(3)(B) and the Conference Report that any treatment of public offerings as equity structure shifts is to be provided only through prospective Treasury regulations.[4]

3. Section 382(g)(4)(C) does not provide an appropriate basis for retroactive public offering regulations.

To the extent that certain statements in the Blue Book relating to the scope and application of section 382(g)(4)(C) might be construed as requiring (or permitting) the promulgation of retroactive regulations that create separate public shareholder groups as a result of the Offering, such statements do not in our view reflect a correct interpretation of Congressional intent.[5]

It is our understanding that the argument that section 382(g)(4)(C) could apply in these circumstances is apparently premised on the notion that where a firm commitment underwriter is a corporation, two corporations are involved in the transaction. It therefore is permissible, the argument continues, to treat the Offering as creating separate public shareholder groups without the benefit of regulations under section 382(m)(5) (which authorizes regulations to apply section 382(g)(4)(C) in "single entity" situations).

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[4] Conf. Rep., at p. II-178. Nor, absent such regulations, should a firm commitment underwriting result in the creation of separate public shareholder groups for purposes of a later "owner shift" calculation via section 382(g)(4)(C). (See discussion in part 3, below.)

[5] See Blue Book, at pp. 304-305 (in particular, n. 28 and Ex. (8)). The "taxable merger" situation of Example (8) in the Blue Book is especially disturbing; for it finds an "ownership change" via section 382(g)(4)(C) even though the Conferees, on the same facts, made clear that regulations treating taxable reorganizations as equity structure shifts would be necessary to reach that result. See Conf. Rep., at p. II-177.

This theory is not articulated in either the Conference Report or the Blue Book, and whatever merit there might be to recognizing a firm commitment underwriter as a shareholder for "owner shift" calculation purposes, we do not believe that Congress could have thought that, prior to the issuance of public offering regulations, a firm commitment underwriter (whose ownership of the issuer's stock is virtually always transitory) should be treated as a second corporation for purposes of section 382(g)(4)(C).

Thus, it is simply unrealistic to view the typical firm commitment underwriting, from start to finish, as anything but a "public offering" transaction which falls within the coverage of section 382(g)(3)(B). Any attempt to bifurcate that transaction into separate pieces -- so as to permit circumvention of the prospectivity directive for the public offering regulations through a strained and hypertechnical reading of section 382(g)(4)(C) -- flaunts the Congressional intent so clearly expressed in the Conference Report.[6]

Indeed, we submit that even if section 382(g)(4)(C) were deemed to apply to a public offering involving a corporate firm commitment underwriter, segregation of the public shareholder group must await regulations which should be prospective in accordance with the Conferees' mandate. It is only reasonable to conclude that if the Conferees did in fact have section 382(g)(4)(C) in mind in this situation, they intended that any public shareholder segregation rules applicable to public offering transactions coming within section 382(g)(4)(C) would be modeled on the equity structure shift regulations and likewise would be prospective. The fact that section 382(g)(4)(C) by its terms cross-references to the equity structure shift rules of subsection (g)(4)(B) confirms this analysis.

4. **Act section 106(d)(2) may expand section 382(g)(4)(C) beyond its intended scope.**

The discussion at page 33 of the Joint Committee Staff Description of the Act (June 15, 1987) indicates that section 106(d)(2) of the Act is designed to confirm an expansive role for section 382(g)(4)(C). That being so, section 106(d)(2) could be interpreted as lending credence to the position that regulations treating public offerings as equity structure shifts, and prescribing the rules for creating separate public shareholder groups in the case of both owner shifts and equity structure shifts, could properly be drafted to apply *retroactively* in the context of firm commitment public offerings. Any such interpretation would contravene the directive of section 382(g)(3)(B) and the Conference Report, and thus would represent a significant *substantive* change in existing law.

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[6] We view likewise any suggestion that all "equity structure shifts" technically also constitute "owner shifts" -- and that, therefore, firm commitment underwritings can be dealt with solely as "owner shifts" and without regard to what any future public offering regulations may provide. Such an analysis would effectively render section 382(g)(3)(B) a nullity.

5. Act section 106(d)(15) is ambiguous as to the precise impact of firm commitment underwritings on ownership change calculations.

Section 106(d)(15) of the Act is troublesome because, in the context of providing transitional relief for pre-September 19, 1986 firm commitment public offerings, it expressly embraces the questionable distinction advanced by the Conference Report footnote referred to earlier. By inference, post-September 18, 1986 acquisitions of stock by a firm commitment underwriter will be counted; but it is unclear (1) whether this would encompass "equity structure shift" calculations, and (2) whether it would permit the retroactive application of shareholder segregation rules to firm commitment public offerings characterized as "owner shifts" under section 382(g)(4)(C). These latter interpretations would be plainly inconsistent with the mandate of section 382(g)(3)(B) and the Conference Report that future regulations addressing the treatment of public offerings will apply only on a prospective basis.

6. Policy behind making public offering regulations prospective is no less compelling for firm commitment offerings.

Section 382(g)(3)(B) reflects the belief that the impossible burden of keeping track of ownership changes resulting from day-to-day public trading of the stock of widely-held companies may not necessarily be present in public offerings or other "single, integrated transaction(s)" where it may be feasible to identify changes in ownership among distinct shareholders groups.[7] As a result, the statute recognizes that by regulation it may be appropriate to treat certain public offerings as equity structure shifts in which separate shareholder groups are created for purposes of calculating changes in stock ownership interests.

At the same time, the Conference Report directive that these regulations be prospective undoubtedly reflects the realization that the public offering rules will involve complicated issues and be difficult to develop[8] and that, therefore, it would be unfair to subject taxpayers retroactively to any such rules. Having left this difficult task to the regulatory process, it seems only logical to conclude that the Congress and the Conferees intended the equity structure shift rules addressing public offerings be applied in the same manner to all public offerings, whether effected by a firm commitment or best efforts underwriting. Put another way, those rules, and the difficult problems which they will seek to resolve, will be exactly the same in either case; it would make no sense to conclude that they be applied on a prospective basis in connection with best efforts underwritings and on a retroactive basis in connection with firm committment underwritings.

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[7] Conf. Rep., at p. II-176.

[8] Explicit guidance will be needed, for example, as to how to determine the beneficial ownership of stock held in street name, by pension plans, mutual funds or other financial institutions, and by foreign holders of record. Rules and appropriate presumptions will also need to be developed for identifying and determining the scope and composition of separate public shareholder groups, as well as the allocation of publicly-offered shares between old and new shareholder groups.

D. Recommended Action by the Committee

In light of the foregoing, we urge the Committee to reaffirm the Conference Report, and to expressly reject any attempt to use the Blue Book or sections 106(d)(2) or (15) of the Act as a basis for applying public offering regulations retroactively from the date of issue in both "equity structure shift" and "owner shift" calculations. Toward this end, we very much would like to work with you in developing appropriate revisions to the language of section 106(d) and any necessary accompanying report language.

We appreciate your consideration of these comments and are of course willing to provide as quickly as possible any further information that you may find helpful.

Respectfully submitted,

Ronald A Pearlman
Ronald A. Pearlman

Herbert N. Beller
Herbert N. Beller

Section 631

BENJAMIN L. CARDIN
3D DISTRICT, MARYLAND

COMMITTEE ON PUBLIC WORKS
AND TRANSPORTATION

COMMITTEE ON THE JUDICIARY

ASSISTANT MAJORITY WHIP

Congreſs of the United States
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Washington, DC 20515

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September 3, 1987

The Honorable Dan Rostenkowski
2111 Rayburn House Office Bldg.
Washington, D.C. 20515

Dear Mr. Chairman:

One of my constituents has expressed concern over a provision of the Technical Corrections Act of 1987 which appears to be a substantive, rather than a technical change, and which imposes an undue hardship on my constituent since the provision apparently has a retroactive effective date.

I have been informed that Section 106(e)(5) grants the Treasury Department the authority to promulgate regulations imposing a tax on a merger between a regular corporation and a regulated investment company. Apparently, the tax would be imposed on the appreciation in the assets of the corporation. I understand that any such regulations promulgated could apply retroactively as if the regulatory authority was enacted as part of the original legislation. Nevertheless, the there does not appear to be anything in the Tax Reform Act of 1986 or the legislative history thereto which discloses a clear intent to impose a tax on such a transaction. Furthermore, I have been informed that the Internal Revenue Service has not interpreted the original provisions of the Tax Reform Act of 1986 to grant such regulatory authority since it recently issued a private letter ruling (PLR 8728027) holding that such a merger was tax-free.

I am persuaded that Section 106(e)(5) is a substantive change in the Tax Code, and I believe that such substantive changes should not be retroactively imposed on taxpayers. I urge that you consider amending Section 106(e)(5) in the mark-up session to provide that regulations issued by the Treasury Department shall not apply to any transaction entered into prior to the date of enactment of the Technical Corrections Bill.

I appreciate your kind attention to this matter.

Sincerely,

Benjamin L. Cardin

Benjamin L. Cardin

National Presto Industries, Inc.
Eau Claire, Wisconsin 54703

JOSEPH H. BERNEY
VICE CHAIRMAN

July 16, 1987

Mr. Robert Leonard
Chief Tax Counsel
Ways and Means Committee
U.S. House of Representatives
Longworth House Office Building
New Jersey and Independence Avenues, S.E.
Washington, D.C. 20515

Re: Comment - Technical Corrections Act of 1987
(H.R. 2636)

Dear Mr. Leonard:

It is obvious from the text of the Technical Corrections Act of 1987 that the Act provides an excellent means of simplifying the tax code by clearing out provisions in the law which have become redundant or unnecessary by virtue of the enactment of the Tax Reform Act of 1986. Section 106(e)(9), (10) and (11) of the Technical Corrections Act is an excellent example of the use of the Technical Corrections Act to eliminate provisions of the Code that have become unnecessary by virtue of the Tax Reform Act. In what strikes me as an excellent job by the Committee staff, the incredibly complicated provisions of Section 301 of the Code have been streamlined and many of that Section's portions have been repealed as "deadwood".

Similarly, the Accumulated Earnings section of the Code should be modified in a similar manner. The Committee has provided in the Technical Corrections Act for a change in the tax rate on accumulated earnings to bring them in line with the individual rates. In conjunction with these technical changes, Congress should repeal Code Section 532(c) as "deadwood".

As you are aware, Code Section 532(c), added by Congress in 1984, made the accumulated earnings tax applicable, for the first time, to widely-held corporations. The legislative history shows that 532(c) was a reasonable Congressional response to the formation of investment corporations which were formed for no true business purpose, but were simply a device to take advantage of the difference between the capital gains tax rate and the dividend tax rate. The investment corporations used their capital to purchase dividend paying stocks of other corporations. The investment corporation, receiving a dividend, was subject only to the nominal tax on the dividend (an effective rate of 6.9%) and, instead of paying these dividends to its shareholders, it accumulated the dividends. The investment corporation's policy was to never pay dividends and accordingly its shares increased in value roughly equal to its dividend income. Shareholders thus paid no taxes on dividends of the underlying stocks held by the investment corporation but could realize income equivalent to the dividend accumulation by selling their shares. Of course, the gain on the sale of those shares was taxable as capital gains (20%) rather than ordinary dividend income (as high as 50%). The Congressional response to this tax avoidance scheme was the passage of Code Section 532(c) which, for the first time, applied the accumulated earnings tax to widely-held corporations. The potential levy of the accumulated earnings penalty rate made the investment corporation an uneconomical means of avoiding taxation and effectively ended these companies, thereby insuring that dividend income would be taxed at the shareholder level at ordinary income rates.

Under the Tax Reform Act of 1986, capital gains shall be taxed at the same rate as dividend income. Accordingly, the Act also insures that the investment corporation device, which converts dividend income into capital gains income, is uneconomical. In fact, under the Act, it would serve no purpose. Likewise, the Act insures that dividend income will be taxed at ordinary rates, for there will no longer be a difference between capital gains and dividend rates. Under these circumstances, Section 532(c) is superfluous and, like Section 301(e), should be repealed as "deadwood".

In addition to the fact that 532(c) is now "deadwood", it is still significant to note that it is not good public policy to apply the accumulated earnings tax to widely-held corporations. In a widely-held corporation, the payment of a dividend or the accumulation of funds for expansion, investment or research and development is a decision best left to a board of directors. However, as a result of the applicability of the accumulated earnings tax to widely-held corporations, there may be a tendency for corporations to pay dividends, even when the corporate resources should be husbanded for important future business expenditures. The ability of the Internal Revenue Service to second-guess the directors by applying the accumulated earnings tax to a widely-held corporation should not be the driving force behind a decision regarding dividend policy. Rather, the checks and balances of the marketplace should be allowed to have their natural and free effect on a widely-held corporation's board of directors. As such widely-held corporations are, by definition, publicly held by many shareholders, it is in the board's interest to make dividend decisions based on the marketplace and the corporation's business needs. The repeal of Section 532(c) will allow corporate directors to determine dividend policy without reference to an unnecessary and punitive application of the accumulated earnings tax.

I am taking the liberty of attaching to this letter a position paper previously provided to members of Congress regarding this issue. I appreciate your attention to these comments and would be happy to meet with you or any members of the staff to discuss these issues.

Best regards,

NATIONAL PRESTO INDUSTRIES, INC.

Joseph H. Berney
Vice Chairman

PROPOSED TECHNICAL CORRECTION TO THE TAX REFORM ACT OF 1986

SECTION 532(c) SHOULD BE REPEALED

I. BACKGROUND

The Tax Reform Act of 1986 is an extremely complex piece of legislation. Moreover, it made sweeping changes to what was an already highly complicated area of the law in a piecemeal fashion -- through amendments rather than by creating an entire new tax code. Under these circumstances one would expect numerous errors of a technical nature due to failures to determine all of the possible ramifications from any one change. That there are so few such oversights, is a tribute to the brilliant execution of the task by Congress and its staffs and is nothing short of remarkable. Nevertheless, there were inadvertent oversights which do require correction. One such oversight was the failure to repeal Section 532(c) to make the accumulated earnings tax law consistent with the alterations the reforms made to the capital gains tax, the corporate income tax, and individual income tax rates.

II. HISTORY OF SECTION 532(c)

The accumulated earnings tax is imposed upon corporations that accumulate earnings and profits (rather than paying them out as dividends) to assist their shareholders in avoiding income taxes. Historically, the tax had not been applied to widely-held corporations. By its very nature, a widely-held corporation does not lend itself to the requisite conspiracy between management and shareholders for tax avoidance. As it is widely-held, there are typically shareholders to whom payment of a dividend is critical (for example, pension funds which have become one of the dominant forces in the stock market owning approximately 40% of publicly traded shares). If the corporate directors wish to retain their positions, they must consider these shareholders who have the power to vote them out directly on an annual basis or to sell their shares (leaving the company vulnerable to a takeover if the stock value drops too far and as a direct result, the directors without their jobs). Unless the corporation is in a true expansionary mode or on the threshhold of such an expansion (in which case the shareholders will be patient about no or low dividends as better prospects are on the horizon), it is definitely in the interest of the directors to pay out dividends simply to retain their positions. Nor is it good public policy to apply the accumulated earnings tax to widely-held corporations. Such application tends to cause dividend pay outs where they are not in the best interest of the shareholders due to fear that the highly punitive accumulated earnings tax (a nondeductible tax of 27 1/2% on the first $100,000 of accumulated earnings and 38 1/2% thereafter) will be imposed by an aggressive Internal Revenue agent. The payment of dividends is best left to the duly elected board of directors. The appropriation and dedication of corporate funds, which are the lifeblood of a corporation, is the most important function of the board of directors. Certainly, it should not be determined by legislative fiat.

Unfortunately, the atypical conspiracy situation between management and shareholders of a widely-held corporation did come into being. It was only possible as a result of the differences between the capital gains tax rate (20%) and the dividend tax rate (for high bracketed individuals as high as 50%). Investment corporations were formed which carried on no true business, but were simply a device to take advantage of the difference between the two rates. Such corporations used their capital to purchase dividend paying stock of other corporations. A corporation which receives a dividend from another corporation is subject to only a nominal tax on the dividend, as it is assumed that the dividend will in due time be disbursed to an individual shareholder of the receiving corporation, who will then pay the normal dividend tax. Dividends should not be subject to tax more than once. The specially formed investment corporations, however, as a stated policy, paid no dividends. Instead they accumulated the dividends they received and used them to purchase additional dividend paying stock. The result was an increase in the price of the shares of such investment corporations roughly equal to the dividends they were receiving, due to the fact that the shares were attractive to individuals who wished to avoid the tax on dividends. The individuals would then sell the shares, realize the "dividend" gain, and pay a lower tax (20% vs. 50%) than the individual would otherwise have paid on the dividends. Literally, a widely-held corporation had been created which was in the sole business of accumulating earnings (dividends from other corporations) for tax avoidance purposes (to permit its shareholders to convert income otherwise taxable at ordinary rates into capital gains).

Congress put an end to such corporations in 1984 by adding section 532(c) to the law, which made the accumulated earnings tax applicable for the first time to widely-held corporations.

III. RATIONALE FOR THE TECHNICAL CORRECTION

Once the transition period is over, as a result of the Tax Reform Act of 1986, individual tax rates will be less than corporate tax rates and the capital gains rate will be equal to the dividend rate. This sweeping change to rates impacted more than the sections concerning rates. To the extent Congress did not modify these other sections to make them consistent with the effect of the rate changes, it should do so now through the Technical Corrections Act of 1987.

One such area is Section 532(c), a 1984 amendment intended to prevent the conversion, through the device of a widely-held public corporation, of dividend income into income taxed at the lower capital gains rates. As capital gains will be taxed at the same rate as dividend income, at the end of the transition period, this section will soon be superfluous. With the change in tax rates, it is also potentially damaging to corporate America. Once the transition period is over, the accumulated earnings tax will be the highest tax in existence -- 38 1/2% versus the top individual bracket of 28% and the top corporate tax of 34%. That provides an enormously powerful incentive to an aggressive Internal Revenue Service agent to second guess a management-shareholder decision to not pay or to pay "low" dividends. The tendency will be to pay dividends, even when resources should be husbanded, for example, for expansions which from a timing point of view should not be made immediately for a variety of reasons (the staff required to properly implement the expansion needs to be hired and trained, the product to be produced requires the successful marketing of a complementary product (e.g., before film for the polaroid camera could be sold, the polaroid camera itself had to be marketed) etc.), which ultimately will be overcome. It is dangerous indeed with the burden of proof on the corporation, to dispute with the Internal Revenue Service whether the decision not to pay out or to pay "low" dividends was tax motivated or whether the reason for retaining capital was done for sound business reasons. With the checks and balances in place through the market system, it is counterproductive to place the determination of the validity of business actions in the hands of the Internal Revenue Service and the courts. Counterproductive, not only to the businesses themselves, but likewise to the U.S. government in terms of the healthy tax base which results from business expansion. The immediate benefits from taxes on current excessive dividend pay outs should not be allowed to outweigh the long term ongoing advantages of an expanding tax base upon which our economy and government will ultimately depend.

IV. RECOMMENDED ACTION

To make Section 532(c) consistent with the changes made to capital gains, individual, and corporate rates, the section should be repealed.

July 17, 1987

STATEMENT OF LEROY E. HOFFBERGER

This statement is submitted to the Ways and Means Committee of the United States House of Representatives by LeRoy E. Hoffberger on behalf of The O-W Fund, Inc. ("O-W") and its shareholders to express O-W's concern with respect to a provision of H.R. 2636, the Technical Corrections Act of 1987 (the "Bill"), that adversely change the current treatment of tax-free mergers between investment companies.

O-W, a diversified investment company (within the meaning of Code section 368(a)(2)(F)), has been actively pursuing, commencing in October of 1986, a tax-free reorganization with a regulated investment company ("RIC") as defined by Code section 851(a). O-W has recently (June 16, 1987) obtained from New York Venture Fund, Inc. ("Fund"), a RIC, a letter confirming its intention to merge with O-W which was countersigned by O-W on July 9, 1987. The proposed merger satisfies all of the requirements for mergers between two investment companies in Code section 368(a)(2)(F) and otherwise qualifies as a tax-free reorganization under Code section 368(a)(1)(A).

The Bill was introduced in the House (H.R. 2636) and Senate (S. 1350) on June 10, 1987 to make technical corrections to the Tax Reform Act of 1986 ("1986 Act") and other recently enacted tax provisions. Provisions in the Bill are generally effective as if included in the original legislation, unless otherwise indicated. Included in the Bill is section 106(e)(5) which would amend Code section 337(d) to direct the Treasury to adopt regulations preventing corporations from circumventing the repeal of General Utilities through the use of a RIC or a real estate investment trust.

According to the description of the Bill by the staff of the Joint Committee on Taxation (dated June 15, 1987), the regulations to be prescribed by the Treasury Department pursuant to Code section 337(d) will require O-W to recognize gain on the appreciated stocks and securities in its portfolio notwithstanding that the proposed merger with Fund will qualify as a tax-free reorganization. The sudden emergence of this proposal will have a significant chilling effect on the proposed merger between O-W and Fund and no doubt to other possible transactions similarly qualifying as tax-free reorganizations.

Prior to the preview of this proposal in the Blue Book published on May 4, 1987, O-W and its advisors had no contemplation whatsoever, and no basis for contemplating, that a tax-free merger with a RIC would result, nonetheless, in recognition of gain on O-W's appreciated portfolio. Indeed, as recently as April 13, 1987, the Internal Revenue Service ruled (in PLR 8728027) that a proposed transaction similar to the one contemplated between O-W and Fund would not trigger gain upon the transfer of an investment company's appreciated portfolio to a RIC.

Much as was the case in 1986 with the repeal of the General Utilities doctrine itself, this offshoot from that repeal must in fairness be accompanied by a transition period which will give O-W and others similarly situated a reasonable time to complete transactions that qualify as tax-free reorganizations with assurance that the regulatory authority granted by Code section 337(d) will not be used to tax their appreciated portfolios in connection with such reorganizations.

The 1986 Act expressly provided through Code section 336(c) that recognition of gain or loss pursuant to the repeal of the General Utilities doctrine shall not apply with respect to any liquidating distribution of property to the extent the reorganization provisions of subchapter C provide for nonrecognition of gain or loss with respect to such property. The only basis for exception to this general rule is the regulatory authority extended to Treasury under Code section 337(d) to prescribe such regulations as may be necessary to carry out the purposes of the 1986 Act amendments to Code sections 336 through 338, including regulations to ensure that such purposes may not be "circumvented through the use of" the tax-free organization and reorganization provisions in Code sections 351 through 368.

The dictionary meaning of circumvention is clear and well known (overreaching, outwitting, or getting the better of by craft or artifice). When Congress enacted Code section 368(a)(2)(F), it confirmed the entitlement of O-W and Fund to a tax-free reorganization provided that O-W satisfies the diversification and other requirements of that provision. Prior to the publication of the Blue Book there was no suggestion that common transactions, such as the proposed merger between O-W and Fund, pursuant to a detailed set of rules under Code section 368(a)(2)(F) which purpose is to limit eligibility for tax-free reorganizations between investment companies, was an artifice of any kind or overreaching in its result.

An example of what constitutes a circumvention of the 1986 Act amendments to sections 336 through 338 within the meaning of Code section 337(d) follows. Suppose shareholders of Corporation A and Corporation B want to liquidate their respective corporations. Assume that Corporation A owns property with built-in gains and Corporation B owns property with built-in losses. The shareholders decide to adopt a plan of merger so that the built-in gains of Corporation A will be offset by the built-in losses of Corporation B upon the subsequent liquidation of the surviving company. Shortly after the merger transaction, the surviving company is liquidated. This transaction would circumvent the repeal of General Utilities through the use of the tax-free reorganization provisions and as such should be within the regulatory scope of Code section 337(d).

It should be pointed out that the circumvention must result from "use of" the tax-free reorganization to avoid the tax on the liquidating distribution. A merger by itself cannot constitute a circumvention for purposes of Code section 337(d) for two independent reasons. First, as noted above, there is an express exception to the 1986 Act repeal of General Utilities with respect to any distribution of property in a tax-free reorganization in Code section 336(c). Second, Code section 337(d) by its own terms applies only to 1986 Act amendments made to subpart B, that is, Code sections 336 through 338.

The Conference Report on the 1986 Act described the purposes to be protected by the regulatory authority under Code section 337(d) as follows (II at 204):

> "The repeal of the General Utilities doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context."

Nowhere is there any suggestion that the gain on a corporation's appreciated property should be taxed in a transaction which otherwise qualifies as a tax-free reorganization.

The 1986 Act expressly provided special rules to tax the "built-in" gain of a C corporation that is converted into an S corporation, Code section 1374. These rules were not even covered by the regulatory authority under Code section 337(d). Moreover, there was no similar rule in the 1986 Act or any suggestion anywhere that there would be similar restrictions on built-in gains in the case of pass-through entities, other than S corporations, including RICs.

Nevertheless, the Joint Committee staff in describing the Bill amendment to the regulatory authority granted by Code section 337(d) announces that there were "built-in gain provisions" in the 1986 Act other than Code section 1374, which applies only to S corporations, and it is the purposes of these provisions that is being protected by regulatory authority that would tax C corporations such as O-W in a tax-free reorganization with a RIC, such as the Fund, because the RIC's status as a pass-through entity would permit it to avoid corporate level tax on the built-in appreciation despite the carryover basis rules.

We respectfully submit that the purposes so announced in May and June as though they were a matter of fact are phantoms and to apply them to established rules for tax-free reorganizations without a reasonable transition period is unfairly blindsiding O-W and similarly situated diversified investment companies. O-W should not be penalized simply because it chose not to request a ruling as in PLR 8728027.

STATEMENT OF WILLIAM T. BRACK
ON BEHALF OF
SOUTHWESTERN BELL CORPORATION

Mr. Robert J. Leonard
Chief Counsel
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1102 Longworth House Office Building
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RE: Technical Corrections Act of 1987:
Correction to Transition Rule for
Section 338 Elections

Dear Mr. Leonard:

The transition rule in the Tax Reform Act of 1986 ("TRA") for elections to treat stock acquisitions as asset acquisitions under Internal Revenue Code ("IRC") section 338, left open an area of uncertainty regarding binding contracts entered into prior to August 1, 1986 which are subsequently modified to account for pre-existing contract rights or actions by courts or administrative agencies. Given the potential punitive tax liability which could accrue from a section 338 election if the Internal Revenue Service ("I.R.S.") takes a contrary position, more certainty is necessary to prevent the current rules from being a trap.

I. The Problem

Prior to the changes enacted in TRA section 631, IRC section 338 provided that a corporation that purchased 80% or more of the stock of another corporation (target) could make an election which caused the target to be treated as if it had sold its assets under section 337 and purchased those assets for the cost of the stock. Section 337, at that time, provided that, with limited exceptions, there would be no recognized gain or loss on the sale. TRA section 631 eliminated both the reference in section 338 to section 337 and the provision in section 337 that there would be no recognition of gain or loss.

The impact of this change can be illustrated by the following example.

Example

"A" corporation has a basis of $100 in depreciable assets with a fair market value of $1,000 and a zero basis in non-depreciable assets with a fair market value of $500. "B" corporation purchases "A" corporation stock from A's shareholders for $1500. "B" corporation makes a section 338 election. Suppose the tax liability from investment tax credit ("ITC") and depreciation recapture is $50. The impact under the old rules and the new is as follows.

Old Rules

"A" is treated as having sold its assets to new "A" for $1500. "A" has a basis of $1000 in depreciable assets and $500 in non-depreciable assets. "A" recognizes no gain as a result of the step-up in basis. "A" has an additional $900 which it can depreciate. These tax benefits would have a present value (depending on depreciation rates on the assets) of approximately $175, less the $50 recapture for a net present value of $125.

New Rules

"A" is still treated as having sold its assets to new "A" and still has an additional $900 to depreciate with a present value of approximately $125. Under the new rules, however, the gain is taxable. "A" has a gain of $1400 which, at a 40% rate of tax, is $560 of tax, plus ITC recapture. "A" owes more than $560 of tax and has depreciation deductions with a present value of only about $125. "A" loses more than $435.

With other transitional rules in the Tax Reform Act, the issue is usually whether the taxpayer is entitled to receive a deduction or credit. If it is later determined that the taxpayer did not qualify under the transition rule then he owes the amount of the tax applicable to the deduction or credit plus interest. With the transition rules for the Section 338 election, however, the taxpayer faces a severe penalty if it is determined that it did not qualify for the transitional rule. Based on the above examples illustrating the impact of the application of the old and new rules, a proper Section 338 election followed by a challenge by the I.R.S. that the contract was not binding would penalize the taxpayer three or more times for being wrong.

Using the above example as a point of reference to the problem with the TRA transition rule, the issue seems to be whether taxpayer is entitled under TRA section 633 to receive tax benefits worth $125. By not repealing IRC section 338, however, but by merely changing the tax treatment of the election, the election becomes a trap for any corporation that incorrectly believes that it is qualified under the transitional rule, with a massive penalty for being wrong.

As a result of the enormous exposure to potential tax liability, a corporation must be certain that it qualifies under the transitional rule in TRA section 633. Unfortunately, the drafting of the rule is susceptible to various interpretations, and does not provide the certainty needed to allow a section 338 election to be made.

An examination of the language of TRA section 633 does not immediately reveal the problem, however. This section reads:

> "(1) IN GENERAL -- The amendments made by this subtitle shall not apply to --
>
> (D) any transaction described in Section 338 of the Internal Revenue Code of 1986 with respect to any target corporation if a qualified stock purchase of such target corporation is made on or after August 1, 1986, pursuant to a written binding contract in effect before such date and the acquisition date (within the meaning of Section 338) is before January 1, 1988."

The problem with the transition rule, which does not appear on its face, originates in the case law and regulations regarding other transitional rules involving binding contract provisions. The problem is that the Internal Revenue Service frequently contests the binding nature of the contract based upon contingencies in the contract or amendments made after the transition date. For example, if a portion of the property of the acquired corporation is not acquired by the acquiring corporation because of a right of first refusal or if such portion of the property cannot be acquired because it is prohibited by an agency or court, the I.R.S. could take the position that the contract on the stock was acquired was not binding.

This problem is considerably worse with regard to corporate acquisitions than with the purchase of equipment. Corporate purchase contracts must contain numerous conditions and contingencies. In addition, most major contracts for the acquisition of other corporations are amended as problems appear up through the closing date for pre-existing contractual obligations or because the Federal Trade Commission or other agency prohibits such acquisition.

The question left open by current TRA section 633 is: are such contracts still binding as of August 1, 1986, even with such conditions, contingencies and amendments? They almost certainly are, because the parties are mutually obligated to fulfill the contract and must act in good faith to fulfill the conditions and satisfy the contingencies. The cost of fulfilling that commitment and having the I.R.S. contend that the contract was not binding, however, may be three or more times the potential benefit. Few purchasing corporations are able to take such a risk.

The legislative history of TRA section 633(c)(1)(D) does provide some assistance by stating that provisions in a contract regarding normal commercial due diligence do not make a contract non-binding and that the terms of the acquisition may vary pursuant to such provisions. This language is, unfortunately, extremely vague. What constitutes "normal" due diligence? Does "vary" mean that the contingency activates a specific formula in the contract, or does it also cover ad hoc amendments adopted after the occurrence of the contingency?

To summarize, TRA section 633 provides a transitional rule intended to cover certain contracts. Nevertheless, in most instances, taxpayers will not be able to use the transition rule because, while the law strongly favors them, the liability in the event the taxpayers do not qualify for the rule will be catastrophic.

An additional problem is faced by some companies that intended to rely on the transition rule and that find the potential liability too high to make a section 338 election. For the purchase of tiered corporations, a section 338 election can increase the tax basis of assets among the tiers. With lower bases throughout the tiers (when the section 338 is not valid under the transition rule), a taxpayer faces multiple levels of taxation and difficulties in reorganizing or selling pieces of the acquired corporations. Extremely complicated and expensive tax planning and requests for private letter rulings will be needed for what would have been routine sales or reorganizations had the section 338 election been available.

II. Proposed Correction

The solution to this drafting problem is to append to TRA section 633(c)(1)(D), the following:

> "Modifications to such a written binding contract made after August 1, 1986 will not cause such a contract to be deemed non-binding so long as these modifications do not increase the amount of property subject to this transitional rule."

We appreciate your addressing this issue. If you have any questions concerning our description of the problem or our proposed solution, I encourage you to contact me (William T. Brack) at 659-0702.

Section 633

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July 23, 1987

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Re: Section 106(g)(5) of the Technical Corrections Act of 1987 -- Addition of a Five-Year Holding Period Requirement to the Transition Rule for Certain Small Corporations

Dear Mr. Leonard:

Section 106(g)(5) of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350)(the "Bill") would amend section 633(d)(6) of the Tax Reform Act of 1986 (P.L. 99-514)(the "Act") to add a five-year holding period to the definition of "qualified corporation" for purposes of transitional relief from certain of the effects of the repeal of the General Utilities Doctrine. If enacted in its current form, the Bill would make this change retroactive to the date of enactment of the 1986 Act. The introduction of a holding period requirement represents a significant substantive change in the law, and not a technical correction, and should not be retroactive.

The adoption of a retroactive effective date for this new requirement would be unfair to many taxpayers who purchased the stock of small businesses after the enactment of the 1986 Act, relying upon the plain language of the statute, which included no such requirement. If a corporate taxpayer purchased the stock of a small corporation from sellers who, it now turns out, did not satisfy the new five-year holding requirement, the buyer would be denied the benefits of a tax-free basis step up under section 338 that it reasonably expected when the terms of the purchase were struck. As a result, the buyer would, in effect, bear an unanticipated corporate level tax on gain on the acquired corporation's assets that had accrued economically when the stock was held by the prior owners.

It would be unfair to deny the benefits of the transition rule retroactively to "qualified stock purchases" under section 338 which have already occurred. Although the Conference Committee Report to the 1986 Act mentions a five-year holding period, and a provision to add one to the Act was included in the concurrent resolution that was introduced at the time (H. Con. Res. 395), the resolution was not enacted, leaving an implication that the plain language of the Act itself could safely be followed.

Moreover, taxpayers have been encouraged to rely on the language of the Act by the Internal Revenue Service's issuance of guidance on the transition rules that makes no mention of a five-year holding period requirement and leaves the clear impression that none applies. In both Rev. Rul. 86-141, 1986-47 IRB 4, and Rev. Rul. 87-4, 1987-2 IRB 6, the Service stated that transition relief applies generally to "any corporation of which more than 50 percent (by value) of the stock is held by ten or fewer qualified persons . . . and the applicable value of which does not exceed $10,000.000."

For the reasons described above, it is respectfully requested that if the Act is amended to add a holding period requirement to section 633(d)(6), that such amendment be made prospective to "qualified stock purchases" after the date of enactment of the Bill or, at the earliest, to such purchases after the date that the Bill was introduced.

Respectfully submitted,

Martin S. Allen

Martin S. Allen, P.C./bja

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July 2, 1987

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Re: Section 106(g)(5) of the Technical Corrections Act of 1987 (Pages 130-131 of the Bill)--Definition of "Qualified Group" for Transitional Rule for Certain Small Corporations--Five Year Holding Period Requirement

Dear Mr. Leonard:

Section 106(g)(5) of the Technical Corrections Act of 1987 (pages 130-131 of the Bill) amends section 633(d)(6) of the Tax Reform Act of 1986 (relating to the transitional rule for certain small corporations) to provide for the definition of a "qualified group" (a new term in the transitional rule) which adds a five year holding period for qualification under the transitional rule.

It is respectfully requested that the five year requirement be either deleted or modified, as discussed below, or that a prospective effective date (with a binding contract provision) be provided.

Although the Conference Report made mention of a five year holding period requirement, section 633(d) of the Tax Reform Act of 1986, as passed, did not contain such a rule. In various releases by the Internal Revenue Service regarding the application of the transitional rules, no mention is made of the five year requirement. See, for example, Rev. Rul. 86-141 and Rev. Rul. 87-4, both of which outline the section 633(d) requirements but make no mention of a five year holding period requirement. Since a section 338 election is permitted under the transitional rule for qualified corporations (and this is confirmed in the "Description of the Technical Corrections Act of 1987" at pages 50-51), this is inconsistent with the five year rule and would leave one to conclude that the five year requirement was intentionally omitted from section 633(d) of the 1986 Act.

Further, since a corporate purchaser of a qualified corporation has the option of obtaining the benefits of a section 338 election, with transitional rule relief, an individual purchaser of a qualified corporation (which definition could have a holding period requirement with respect to the seller) should likewise have the option of liquidating a qualified corporation under the transitional rule. The five year rule as proposed puts an unfair disadvantage on an individual acquirer who desires to acquire an otherwise qualified corporation and immediately liquidate that corporation.

Your attention to this matter would be most appreciated. Please feel free to contact me if you have any questions regarding the above.

Sincerely,

John P. Barrie

JPB:jb

STATEMENT OF GEORGE BRODE, JR.
CONCERNING REQUEST FOR
PERMANENT RELIEF FROM REPEAL OF
GENERAL UTILITIES FOR SMALL
"QUALIFIED CORPORATIONS"

===

My name is George Brode, Jr. I am a sole tax practitioner specializing in Federal income tax matters for closely held corporations and their shareholders in Chicago, Illinois. I have recently acted as Special Tax Counsel to the Illinois State Bar Association and the Chicago Bar Association, past Chairman of the Federal Taxation Section of the Illinois State Bar Association, past Chairman of the Subcommittee on Redemptions, Committee on Closely Held Corporations, American Bar Association Section of Taxation, author of BNA Tax Management Portfolio 8-4th Corporate Acquisitions - - Planning, and General Editor of a two volume book entitled Closely Held Corporations published by the Illinois Institute for Continuing Legal Education. The following comments reflect my own personal opinions and should not be construed as representing the opinion of any bar association.

POSITION

I believe that Congress should make permanent the transitional relief rule currently set forth in Act Section 633(d) of the 1986 Tax Reform Act. That provision, which is due to expire on January 1, 1989, provides temporary relief for "qualified corporations" from the general rule requiring repeal of General Utilities.

I. Legislative History

The repeal of the General Utilities doctrine will result in significantly more tax for closely held corporations (i.e., small family corporations whose stock is not publicly traded on a national exchange) than was formerly the case under prior law Sections 336, 337, and 311(d). In that regard, the Senate Finance Committee proposal ("SFC Proposal") noted that:

> ". . . the impact of repeal of General Utilities (and the consequent need for some form of relief) would fall almost exclusively upon small, closely held businesses, and that large, publicly held corporations would rarely be affected." Testimony of John S. Nolan at 148, 151 noted in Senate Finance Committee Proposal, "Subchapter C Revision Act of 1985," at 63, prepared by the staff of the Senate Finance Committee and issued in May, 1985. See also 6, footnote 24, 7-8, and 62-68.

In discussing relief from repeal of the General Utilities doctrine, the SFC Proposal at 62 stated that:

> "Many people who testified at the October, 1983 hearing advocated some form of relief from the repeal of General Utilities (footnote omitted). The original proposal contained in the Staff Report suggested the possibility of transitional relief in the form of a phase-in of the corporate capital gains tax over a 10-year period (footnote omitted). Several people testified that such relief would be inadequate, and that some permanent relief was essential (footnote omitted).
>
> In deciding what type of permanent relief, if any, might be appropriate, two questions had to be resolved: (1) in what type of transactions should relief be provided; and (2) what form should the relief take?"

Thereafter, the SFC Proposal suggested adoption of permanent relief to shareholders of closely held corporations in the form of an upward basis adjustment to their stock to reflect corporate level tax paid on long held capital assets (generally assets held by a corporation for more than 5 years) in certain corporate acquisitions and liquidations involving small businesses (generally defined to mean corporations with a fair market value of up to $1 million, and in decreasing amounts up to $2 million to prevent a cliff effect). SFC Proposal at 6-8, 63-68, 239-241.

Although it recommended a different type of relief measure, the House Ways and Means Committee Proposal on recognition of gain or loss on distributions of property in liquidations (proposed Section 331 through 335 of H.R. 3838 reported on December 7, 1985 at 274 though 291) similarly believed that permanent relief for small closely held corporations was necessary. The House proposal suggested a two-step approach. First, liquidation of an "active business corporation" would avoid recognition of gain or loss on liquidating distributions of long-term capital assets to the extent of its "qualified stock." The term "qualified stock" meant stock owned by 10% or more noncorporate shareholders for at least 5 years (or the life of the corporation, if less than 5 years). Secondily, a general 10% dividend received deduction would apply to all corporations whether publicly traded or closely held.

II. The '86 TRA Transition Rules Provide Only Temporary Relief

The proposal that was finally adopted in Act Section 633(d) permits small "qualified corporations" that liquidate or convert from C status to S status before January 1, 1989 to avoid the impact of repeal of General Utilities, but no relief is provided beyond that date. In essence, TRA '86 provides temporary rather than permanent relief.

A "qualified corporation" is defined in Act Section 633(d)(5) to mean a small closely held corporation 50% (by value) of whose stock is held by ten qualified persons (individuals, estates, or trusts) where the corporation has a value of $10 million or less. A 100% benefit for long-term capital assets applies to corporations having a value of $5 million or less, while a pro rata reduced benefit on such assets applies to corporations having a value between $5 million and $10 million.[1]

---

[1] Act Section 633(d)(4) establishes an applicable value as of the date of the plan of liquidation, or if greater, on August 1, 1986.

If a "qualified corporation" liquidates before 1989, it may secure partial relief from the double tax impact of repeal of General Utilities. Partial relief means that such corporation would not be subject to recognition of gain in connection with a sale of its assets in the same fashion as under the nonrecognition of gain rules of prior law Section 337. However, gain will be recognized for certain items under Act Section 633(d)(2), including: (1) ordinary gain or loss items (such as prior recapture items under Sections 1245, 1250, LIFO inventory, and tax benefit theory), (2) short-term capital gains, and (3) any gain to the extent that Section 453B applies (see generally Act Sections 633(d)(1)-(7)).

In a similar fashion, if a "qualified corporation" after 1986 but before 1989 converts from C corporation status to S corporation status and then liquidates, Act Section 633(d)(8) provides "rules similar to" those accorded qualified corporations that liquidate before 1989.[2] This transaction would be governed by prior Section 1374 rather than Section 1374 as revised by TRA '86. This means that prior law Section 337 nonrecognition treatment will continue to apply to built-in long term capital gains (i.e., from capital assets held for more than six months). See Rev. Rul. 78-89, 1978-1 CB 272. In addition, Rev. Rul. 86-141, IRB 1986-49, 6, makes it clear that such relief does not extend to items described in Act Section 633(d)(2), which include ordinary income items, short-term capital gain, and Section 453B gain.

Some of the technical issues that need to be addressed by Regulations relate to (i) the manner of valuing a corporation in order to determine whether it is a "qualified corporation," (ii) explaining how prior nonrecognition of gain benefits of Section 337 and the new "built-in" gain rules of Act Section 633(d)(2) apply to "qualified corporations" that liquidate or make an S election prior to January 1, 1989, and (iii) the interplay between the Section 337 nonrecognition of gain rules and the alternative minimum taxable income of revised Section 56.

III. Harsh Impact of Repeal on Closely Held Corporations

The example below indicates the impact repeal of General Utilities will have on a closely held corporation that liquidates on or after January 1, 1989:

Facts: Assume that target corporation's assets are acquired in 1990 for $10,000,000 and that it has a nominal or zero basis in those assets. Assume further that the shareholders have a nominal or zero basis in their stock, and the target corporation has no assets that generate ordinary income or investment credit recapture. The gain under the 1986 TRA would be taxed as follows:

a. Gain of $10,000,000 is taxed to target corporation at 34% resulting in tax of $3,400,000. Under prior law, any depreciation, investment credit, LIFO inventory (as well as tax benefit theory gain) would be subject to recapture. The remaining balance of the gain was not subject to tax because under former Section 337 such gain was not recognized at the corporate level. Thus, the difference in tax to target corporation would be $3,400,000, i.e., $3,400,000 in tax under the new law versus zero tax under the prior law.

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[2] Rev. Rul. 86-141, IRB 1986-49, 6 which interprets the application of the new law to S corporations, is silent as to what rule applies if a "qualified corporation" makes an S election on or after January 1, 1987 but before 1989 and then liquidates within three years of making the election. The ruling does suggest, however, that prior Section 1374 will apply to the disqualified portion of capital gain between $5 million and $10 million. Regulations should clarify this issue and provide that since a "qualified corporation" can liquidate before 1989 and secure prior Section 337 nonrecognition of gain treatment, a liquidation by an S corporation during that same time frame should be similarly treated.

b. Under the new law, after the payment of $3,400,000 in tax at the corporate level, the balance of the $6,600,000 proceeds would be distributed to the shareholders. Gain at the shareholder level would be $6,600,000, i.e., $6,600,000 less their zero basis in their stock. Tax at the shareholder level would be $1,848,000, i.e., 28% times $6,600,000.

c. Under prior law, assuming no depreciation, investment credit, or LIFO inventory recapture at the corporate level, the full $10,000,000 in proceeds would be distributed to the shareholders. The gain at the shareholder level was $10,000,000 (i.e., $10,000,000 less their nominal or zero basis in their stock). Tax at the shareholder level would be $2,000,000, i.e., 20% times $10,000,000.

d. Total taxes to both parties - -

New law:

Corporate level	$3,400,000		
Shareholder level	1,848,000		
Total taxes		$5,248,000	
Net After Tax Proceeds			$4,752,000

Prior law:

Corporate level	- 0 -		
Shareholder level	$2,000,000		
Total taxes		$2,000,000	
Net after tax proceeds			$8,000,000
Increase in taxes from prior law		$3,248,000	
Reduction in net after tax proceeds			$3,248,000

e. In essence, the overall tax under the new law is $5,248,000 or 52.48%. Under the prior law, assuming there were no recapture items, the same transaction would have been taxed at $2,000,000 or 20%. A $3,248,000 increase in tax from $2,000,000 to $5,248,000, represents an increase of 162.4% in the effective rate of tax on the exact same transaction.[3]

The Senate Finance Committee felt that one of the principal problems presented by the General Utilities doctrine was the bias in favor of liquidating transactions which ". . .may encourage merger and acquisition activity." SFC Proposal at 42. This activity was ordinarily undertaken by large, publicly traded corporations, rather than by small closely held corporations. To ameliorate ". . . the concern that the repeal of General Utilities would result in a 'double tax' on 'largely inflationary' gains on long-held assets of small businesses" the Senate Finance Committee believed that some form of permanent relief from the repeal of the General Utilities doctrine was necessary for closely held corporations. SFC Proposal at 6-8.

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[3] By way of alternative, if General Utilities were not repealed and Section 337 remained in effect, the impact of the 1986 TRA would be to tax the gain at 28% rather than at 20%. Under this scenario, tax at the shareholder level would have been $2,800,000 (i.e., 28% times $10,000,000). Under those facts, the increase in taxes of $2,448,000 from $2,800,000 to $5,248,000 would represent an increase of 87.43% in tax from prior law.

I have studied various alternative proposals including one that would provide relief from repeal of the General Utilities rule to corporations whose stock is not publicly traded and another that would preserve double taxation of corporate income yet limit the amount of gain that would be imposed at the shareholder level. It is my opinion that the former is not politically feasible, and that the latter while technically feasible is too complex for consideration at this time.

I therefore concur with the original Senate and House position that relief from repeal of General Utilities should be made permanent for closely held corporations, as well as with the substantive approach adopted by the Conference Report in Act Section 633(d) to implement that relief. I disagree only in the fact that I believe that the relief should have been made permanent rather than temporary. Accordingly, it is my position that the small "qualified corporation" exception should be made permanent.[4]

This permanent relief approach is simple to enact, would better serve the original purpose behind repeal of the General Utilities doctrine, and would prevent harsh extraction of tax on largely inflationary gains from long-held assets of small family held businesses.

Respectfully submitted,

s/George Brode, Jr.

George Brode, Jr.

---

[4] I believe that modification to the August 1, 1986 time period set forth in Act Section 633(d)(4) for measuring the applicable value of stock of a "qualified corporation" should be considered. Such time period could commence, for example, 2 years prior to the adoption of the plan of liquidation.

COMMENTS
ON
H. R. 2636

Mr. Robert J. Leonard, Chief Counsel, Committee on Ways and Means, United States House of Representatives, 1102 Longworth House Office Building, Washington, D. C. 20515.

Dear Sir:

I have the following comments concerning the Technical Corrections Bill of 1987.

These refer to subtitle D of Title VI of the TRA of 1986, and particularly the transitional provisions of Section 633.

I am pleased to note that § 106(g)(3) activates the transitional rule for certain small corporations by correcting the words "this section" to read "this subtitle".

I believe that there still remains, however, a doubt about the complete efficiency of the use of old code section 333 for such small corporations because of the failure completely to deal with the continued availability of old code section 333 in its provision for the non-realization of gain which might otherwise increase earnings and profits, and thus produce additional stockholder ordinary income on liquidation and other distributions of appreciated property.

Revenue Ruling 87-1, IRB 1987-1, tried to deal with this in the context of Section 1804(f) of the TRA of 1986 and its amendment of section 312(b) of the code. It seems to me unsatisfactory to have to rely on a Committee Report in the early stages of enactment to show that the Congress did not mean what it clearly said.

I suggest a clear statement that, but for the exceptions and limitations specifically stated, under the provisions of subsection 633(d) of TRA of 1986, the provisions of old code section 333 are to govern corporate and stockholder tax in exactly the same way that they would have pertained pre-TRA of 1986.

If there would be a purpose further to explain my position in person, I stand ready to attend any hearings to which I may be invited.

I am an attorney, certified specialist in taxation, with the firm Macfarlane, Ferguson, Allison & Kelly, Tampa, Florida. At the moment, I have no client actively pursuing a section 333 liquidation, although I presume there may be such when such an activity may be safely pursued.

George W. Ericksen, Esquire
215 E. Madison Street
Tampa, Florida 33602
(813)223-2411

STATEMENT OF IU INTERNATIONAL CORPORATION

This statement is submitted by IU International Corporation, 919 North Market Street, Wilmington, Delaware, with executive offices at 1500 Walnut Street, Philadelphia, Pennsylvania. IU International Corporation (IU) is a diversified services company with operations in food and inventory distribution, environmental services and trucking services. IU has operations concerning one or more of these services in Pennsylvania, Illinois, Texas, Florida, Kansas, Tennessee, Ohio, Colorado, West Virginia, Delaware, Alabama, Arkansas, Georgia, Indiana, Michigan, Minnesota, Missouri, New Jersey, New York, Oklahoma, California, Maine, New Hampshire, Oregon, Washington, Wisconsin, Massachusetts, Connecticut, Montana, South Dakota, Rhode Island, Nebraska and North Dakota, as well as several other states. This statement relates to a proposed technical amendment to the Tax Reform Act of 1986, specifically to section 633(f) of that legislation.

On October 2, 1973, IU owned approximately 86 percent of Canadian Utilities Limited (CUL), an Alberta-based, regulated Canadian natural gas and electric utility company. Pursuant to direct and indirect pressure by the Canadian Government to increase Canadian ownership of Canadian based companies, particularly in the energy business, IU had sought to increase Canadian ownership in CUL and reduce the IU interests in CUL. By November 1979, IU's ownership in CUL had dropped to approximately 58 percent. This pressure continued, however, and became particularly acute by 1980. In fact, as far as could be determined, no other Canadian gas or electric utility had the level of non-Canadian ownership and control IU had in CUL. In addition, IU was under statutory/regulatory requirements in the United States to limit the percentage of IU stock owned by non-United States' citizens.

Consequently, in 1980, IU entered into a transaction which would both reduce the non-Canadian ownership of CUL and reduce the Canadian/foreign ownership of IU. Or stated differently, the transaction would increase Canadian ownership of CUL and increase United States ownership of IU. In essence, an unrelated Canadian company made a tender offer to buy IU shares. After purchasing those IU shares, this Canadian company exchanged the IU shares with IU for IU's CUL shares. Based on a reading of the then current law I.R.C. §311(d)(2)(B), two law firms gave opinions to IU that the exchange was non-taxable. Indeed, the transactions met the literal statutory requirements, and were within the intent of the statute. Subsequent to the IU transaction, two other publicly-held companies, Esmark and Brunswick, undertook substantially identical §311(d)(2)(B) transactions.

In 1982, Congress repealed §311(d)(2)(B) so that these exchanges would be taxable in the future. Nevertheless, the Internal Revenue Service alleged retroactively that all three of the transactions (IU, Brunswick and Esmark) would be taxable. In September 1986 (the date of Conference action on the Tax Reform Act), all three companies were in some stage of audit procedures with the IRS.

Section 633(f) of the 1986 legislation effectively rejects the Service's position but only with respect to one (Brunswick) of the three affected companies. Section 633(f) does not technically apply to the Esmark and IU transactions even though they are essentially identical and, in fact, preceded and served as the pattern for the Brunswick transaction. Simple fairness requires that the existing provision should not be confined to a single company but should be expanded to cover the other two companies in identical situations.

H.R. 2636 should remove this perhaps unintended unfairness and give equal relief to all three companies.

CARLTON AND JOHNSON
PUBLIC ACCOUNTANTS

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June 18, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Technical Corrections Bill of 1987 - H.R. 2636 §10b(g) - 5 Year Holding Period As It Relates to a TRA §633(d)(6) Definition and Special Rules - For a Qualified Group.

Dear Mr. Leonard:

As I am sure you are aware of, Technical Corrections is making what I believe to be a substantial change in the original Statute enacted under the Transition Rules by introducing a 5 year holding period as noted above.

I am sure from my experience, as well as other practitioners, that deals have been made in which the 5 year holding period has not been considered because it is not in the original Statute. I am puzzled by the restriction in any event. It seems to me that if the intent of Congress were to provide a true opportunity for the small corporation to liquidate during a transition period, the further complication of a 5 year holding period may neutralize that intent.

I believe that the 5 year holding period should be eliminated from the Technical Corrections Act. The 5 year restriction is an unreasonable test that will be difficult to enforce and in my judgment truly frustrate congressional intent.

I would be pleased to discuss this with you.

Respectfully submitted,

Robert L. Johnson CPA

ROBERT L. JOHNSON
CERTIFIED PUBLIC ACCOUNTANT

SHUTTS & BOWEN
ATTORNEYS AND COUNSELLORS AT LAW
(A PARTNERSHIP INCLUDING PROFESSIONAL ASSOCIATIONS)
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PLEASE REPLY TO
WEST PALM BEACH OFFICE

July 7, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill of 1987

Dear Mr. Leonard:

A review of the Description of the Technical Corrections Bill of 1987 prepared by the staff of the Joint Committee on Taxation dated June 15, 1987 reveals a discrepancy with the actual bill itself. Part VIE-13c of the explanation, dealing with transition rules to the repeal of the General Utilities Doctrine for certain small corporations, states that "the bill clarifies that a qualified corporation eligible for the special delayed effective dates does not recognize gain on distribution of installment obligations that are received in exchange for long term capital gain property . . . where the distribution of such obligations would not have caused corporate level recognition under Sections 337 and 453B(d)(2) as in effect prior to the Act."

A review of the relevant sections in the Technical Corrections Bill does not indicate that such changes have been made.

The relevant provision relating to the corporate level recognition of gain on disposition of installment obligations appeared in Section 633(d)(2)(C) of the Act. Section 106(g)(4) of the Technical Corrections Bill indicates an amendment to this portion of the Tax Reform Act but does not make reference to gain recognized pursuant to the disposition of an installment sale obligation. Rather, this provision relates to gain on the sale of corporate assets wherein the corporation has a carryover basis in such assets and where the purpose of the transfer of the asset to the corporation was to secure the benefits of the transition rule. It would seem that this amendment should be added as a new subparagraph (d) of Section 633(d)(2) of the Tax Reform Act and Section 633(d)(2)(C) as currently existing should be amended to provide that dispositions of installment sales by a qualified corporation will not cause the corporation to recognize corporate level gain unless the installment obligation relates to the sale of an ordinary income asset.

Very truly yours

Marvin A. Kirsner

Statement of Monumental Corporation

Background

Prior to the 1986 Act, a corporation did not recognize gain or loss on a distribution (or deemed distribution) of its assets to shareholders in liquidation. The statutory provisions (including section 338) providing for this result are sometimes referred to as the General Utilities rule. This rule was repealed by the Tax Reform Act of 1986 effective, in general, for liquidations, after December 31, 1986.

Monumental Corporation, Baltimore, Maryland, was acquired by Aegon NV on September 3, 1986. Monumental Corporation wishes to make a section 338 election for 1986, but it is unable to do so because of the uncertainty of the effect of such an election. This problem is explained below.

Problem

On April 7, 1986, the Internal Revenue Service, in Announcement 86-47 (Attachment A), indicated that it was studying the tax effects of an insurance company acquisition where a section 338 election was involved (relating to a step-up in basis of assets of the acquired insured company). As of July 1, 1987, no further public announcement had been made with regard to the result of this study.

In a letter dated November 19, 1986 to Messrs. Hughes and Harman (Attachment B), the Chief Counsel of the IRS, William F. Nelson, stated that if this issue -- the effect of section 338 elections on post-April 6 insurance company acquisitions -- "is raised in the course of an examination, I expect it to be resolved on the same basis as other potential tax controversies with respect to which the Service has not adopted a firm interpretation or position."

The result of the IRS statements is that an insurance company electing section 338 after April 6, 1986, and before January 1, 1987, will not know the IRS position as to the tax consequences of such an election. The IRS position had been clear for over 28 years (January 1, 1958 - April 7, 1986); life insurance companies were not taxed at the corporate level if a section 338 election was made because the General Utilities doctrine incorporated into section 338 applied to insurance companies, as well as to all other corporate taxpayers.

Discussion

Whatever questions the IRS may have had with respect to an insurance company election under section 338 should be moot since the General Utilities rule was repealed by the 1986 Act.

In view of:

(1) the repeal of the General Utilities doctrine as of January 1, 1987,

(2) the acceptance by the IRS of this doctrine applying to life insurance companies for over 28 years, and

(3) the IRS refusal to state its position for a nine-month period (April - December, 1986),

we believe the IRS position is unfair and discriminatory. It treats similarly situated taxpayers differently, depending solely on whether an acquisition occurred before or after April 7, 1986. The law was not changed by Congress until 1987.

It is impossible to make an intelligent election when the rules are unknown.

Moreover, the Service will not even state whether or not its position will change until after a taxpayer has made an election, filed a tax return and been audited!

Recommendation

Accordingly, we suggest an amendment be made to the transitional rule provisions of the 1986 Act requiring the Service to continue to apply its historical position with respect to section 338 elections by insurance companies for the nine-month period of April 7 - December 31, 1986. This provision could be included in the 1987 Technical Corrections Act, H. R. 2636.

There is attached a statutory draft to accomplish this result (Attachment C).

We do not believe this proposed amendment involves a revenue loss because it simply requires the IRS to maintain its historical position until January 1, 1987, when the law was changed. We do not believe that the revenue estimtes under the 1986 Act included any revenue attributable to a possible administrative change by the IRS in its 28 year position as to how section 338 applied to insurance companies.

Submitted By,

Vester T Hughes Jr.
Vester T. Hughes, Jr.
Hughes & Luce
1000 Dallas Building
Dallas, Texas 75201

William B. Harman Jr.
William B. Harman, Jr.
Davis & Harman
1455 Pennsylvania Avenue, N.W.
Washington, D. C. 20004

ATTACHMENT A

SEC. 338—STOCK PURCHASES TREATED AS ASSET ACQUISITIONS

• *IRS is considering whether to increase acquired insurance company's taxable income when election is made to treat stock purchase as asset acquisition.* ANNOUNCEMENT 86-47

The Internal Revenue Service is considering the question whether an insurance company's taxable income should be increased by any excess reserves that arise when an election is made under Section 338 to treat the purchase of its stock as an asset acquisition. That situation can arise, for instance, if the parties allocate some of the value of the acquired insurance company to an asset (other than goodwill) identified as "insurance contracts in force." Such allocation reflects the fact that the amount of the reserves exceeds the amount that an unrelated party would require as consideration for agreeing to assume the net liabilities underlying the insurance contracts of the acquired company.

Should the IRS decide that income is properly increased in this situation, that decision will not affect insurance company acquisitions occurring before April 7, 1986. Also, the IRS will not increase the income of an acquired insurance company in analogous situations in which former Section 334(b)(2) applies to the liquidation of an acquired insurance company.

Full Text: The Internal Revenue Service is considering whether the rules of subchapter L of the Internal Revenue Code (and, in the case of life insurance companies, section 1.817-4(d) of the Income Tax Regulations) and/or the "tax benefit" rule require the taxation of income from the release of certain reserves when an election is made under section 338 of the Code to treat the purchase of stock of an insurance company as an asset acquisition. For instance, if the parties to an insurance company acquisition allocate some of the value of the acquired company to an asset (other than goodwill) identified as, for example, "insurance contracts in force," then that allocation reflects the fact that the amount of the reserves of the acquired company exceeds the amount that an unrelated party would require as consideration for agreeing to assume the net liabilities underlying the insurance contracts of the acquired company. The Service is considering whether acquired company's taxable income is properly increased by the amount of that excess.

Should the Service decide that income is properly increased in this situation, then as an exercise of the Commissioner's authority under section 7805(b) of the Code, the Service will not so increase the income of an acquired insurance company, provided that the acquisition date, as defined in section 338(h)(2) of the Code, occurred before April 7, 1986, the date of publication of this announcement. In addition, under the authority of section 7805(b), the Service will not so increase the income of an acquired insurance company in analogous situations in which former section 334(b)(2) applies to the liquidation of an acquired insurance company.

ATTACHMENT B

CHIEF COUNSEL
Internal Revenue Service
Washington, DC 20224

NOV 10 1986

Vester T. Hughes
Hughes & Luce
1000 Dallas Building
Dallas, Texas 75201

William B. Harman, Jr. ✓
Davis & Harman
1445 Pennsylvania Ave., N.W.
Suite 1200
Washington, D.C. 20004

Dear Vester & Bill,

I am writing to follow up on our meeting of last month regarding the question whether the seller of a life insurance business should be required to recognize income on the release from liabilities under the insurance contracts under section 1.817-4 of the Income Tax Regulations.

As you know, Treasury and the Service previously reached a decision that, whatever the correct answer may be as a technical matter, section 7805(b) relief would be granted only for transactions occurring before April 7, 1986. After a great deal of thought and consideration, I have decided not to change that decision. If this issue is raised in the course of an examination, I expect it to be resolved on the same basis as other potential tax controversies with respect to which the Service has not adopted a firm interpretation or position.

Sincerely,

WILLIAM F. NELSON

Department of the Treasury

ATTACHMENT C

Statutory Draft

The following amendment will require the IRS to continue to apply its pre-April 7, 1986, rules to insurance company acquisitions occurring after April 6, 1986 and before January 1, 1987:

SEC.______. AMENDMENT RELATED TO SECTION 633 OF THE 1986 ACT.

Subsection (e) of section 633 of the Tax Reform Act of 1986 (relating to other transitional rules) is amended by adding at the end thereof the following new paragraph:

> "(9) (A) Any transaction described in section 338 of the Internal Revenue Code of 1986 for which the acquisition date (as defined in subsection (h)(2) of section 338) occurs after April 6, 1986 and before January 1, 1987 shall be governed by the rules referred to in IRS Announcement 86-47 as applied prior to the date of such publication.
>
> (B) In the case of any transaction described in subparagraph (A), the time for making an election under paragraph (g) of such section 338 shall not expire before the 60th day after the date of enactment of this Act. A section 338 election made in accordance with the preceding sentence shall revoke and supercede a protective carryover basis election under section 1.338-4T(f)(6) of the Income Tax Regulations that previously was made with respect to a transaction described in subparagraph (A)."

Comments of Alfred H. Moses and Henry J. Birnkrant, Covington & Burling

We wish to propose for the Committee's consideration certain technical corrections to Section 1374 of the Internal Revenue Code of 1986 (the "Code") and Section 633 of the Tax Reform Act of 1986, Pub. L. No. 99-514 (the "1986 Act") that are necessary to prevent Section 1374 of the Code (imposition of tax at the corporate level on gain from the disposition of assets) and Section 633 of the 1986 Act from imposing arbitrary and unintentionally adverse effects upon S corporations that are successor corporations to existing S corporations.

Section 633(b) of the 1986 Act, which sets forth the effective date for the 1986 Act amendments to Section 1374 of the Code, provides that any corporation that is an S corporation pursuant to an election made after December 31, 1986, is taxed under Section 1374 of the Code, as amended by the 1986 Act. Section 633(b) of the 1986 Act does not contain a provision directing that predecessor and successor corporations be treated as one corporation.

The failure of the 1986 Act to clarify the effective date provision as applied to successor corporations produces anomalous results. A corporation that elects after December 31, 1986, to be taxed under Subchapter S is subject to Section 1374 of the Code, as amended by the Tax Reform Act of 1986, even if such corporation is a successor to an S corporation that validly elected prior to January 1, 1987, to be taxed as an S corporation.

The juxtaposition and interaction of this effective date provision with Section 1374(c) of the Code extends this problem. Section 1374(c) of the Code provides that an S corporation that has always been taxed as an S corporation is not subject to the corporate level tax imposed by Section 1374(a) of the Code. Section 1374(c) further provides that an S corporation and a predecessor corporation are treated as one corporation, but solely for purposes of determining whether the S corporation has always been taxed as an S corporation. Accordingly, if a newly-formed S corporation is a successor to a predecessor corporation that was never a C corporation, the newly-formed S corporation is not subject to Section 1374(a) of the Code, as amended by the 1986 Act, even if the newly-formed corporation elected to be an S corporation after December 31, 1986. Thus, the determination of whether Section 1374 of the Code, as amended by the 1986 Act, applies to an S corporation that elected to be taxed as an S corporation after December 31, 1986, but that is a successor corporation to an S corporation that elected to be taxed as an S corporation prior to January 1, 1987, depends solely on whether the predecessor corporation was ever a C corporation. Any history of the predecessor corporation being a C corporation, regardless of when, subjects a newly-formed successor S corporation to Section 1374, as amended by the 1986 Act.

There are no sound policy grounds for imposing this result on taxpayers. Apparently, without intending to do so, Congress has imposed a substantial penalty on a split-off, split-up or spin-off of a successor corporation from an S corporation that elected prior to January 1, 1987 to be taxed as an S corporation. This penalty clearly contradicts the policy underlying Section 355 of the Code, which permits divisions of one or more businesses without adverse tax consequences.

We urge this Committee to cure this unintended and undesired result by amending Section 633(b) of the Tax Reform Act of 1986 by adding at the end thereof the following sentence: "An S corporation and any predecessor corporation shall be treated as one corporation for purposes of the preceding sentence." This language is identical to the language in Section 1374(c) of the Code and accomplishes the tax policy objectives of Section 633(b) of the Act.

The rules of Section 1374(d) of the Code, as applied to an S corporation that is a successor to an S corporation, also produce tax consequences that are clearly unintended. Under Section 1374(d) of the Code, the terms "net unrealized built-in gain", "recognized built-in gain", and "recognition period", all of which are used in determining the amount and incidence of the corporate level tax imposed by Section 1374(a) of the Code, are defined by reference to the beginning of the first taxable year for which a corporation elects to be an S corporation. For purposes of Section 1374(d) of the Code, the determination of the first taxable year for which a corporation elects to be an S corporation is made without regard to an election by a predecessor corporation to be an S corporation.

This clearly produces an unintended result. The disposition by an S corporation of appreciated property it received from a predecessor S corporation in a valid Section 355 split-up, split-off, or spin-off produces recognized built in gain that is subject to tax at the corporate level, even if such assets would not have given rise to any corporate level tax or built-in gain if disposed of by the predecessor corporation. The recognition period during which such a disposition will cause a corporate level tax liability to arise starts anew with the creation of the successor S corporation. Finally, the net unrealized built-in gain, the amount of corporate level tax which the newly-formed S corporation can incur, will be equal to the difference between the fair market value and the adjusted basis it has in its assets on the effective date of its S election, regardless of whether the predecessor S corporation had any unrealized built-in gain.

Taxpayers may, under Section 1374(c), avoid these unintended results, but only if the predecessor corporation was never a C corporation. In such cases, the successor corporation appears to avoid the tax imposed by Section 1374, including the taint of its assets and the new 10 year recognition period. On the other hand, if the predecessor was ever a C corporation, the successor corporation must treat each of the appreciated assets it acquires in the corporate division as "tainted" with unrealized built-in gain to the extent of that fair market value of such assets exceeds its basis in such asset at the time the new corporation is formed, and must begin a new 10 year recognition period.

Thus Congress has indirectly and unintentionally denied the benefits of Section 355 to an S corporation that is a successor corporation to an S corporation that was, at one time, a C corporation. There is no policy justification for such a denial.

As was the case with the effective date provision of Section 633(b) of the 1986 Act, these unintended results can be avoided by adding to Section 1374(d) a new paragraph, paragraph (8), to read as follows:

> (8) TREATMENT OF SUCCESSOR CORPORATIONS. - If an election under Section 1362(a) has been in effect with respect to each of the taxable years of a corporation, the first taxable year for which an election under Section 1362(a) is in effect for any predecessor corporation of such corporation shall be the first taxable year for which such an election is in effect for such successor corporation.

It is our view that the changes proposed above would correct the unintended imposition of a penalty on S corporations that are successor corporations to existing S corporations. We would be pleased to answer any questions you might have with regard to these proposed changes.

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July 16, 1987

The Honorable Daniel Rostenkowski
Chairman Committee on Ways and Means
House of Representatives
Longworth Office Building
Washington, D.C. 20515

Re: General Utilities Rule
Transitional Rule Amendment

Dear Mr. Chairman:

In connection with the current procedure of the House Committee on Ways and Means of accepting public comments until July 17, 1987 relating to proposed technical amendments to the Tax Reform Act of 1986, we wish to advise that we plan to propose at a future date an amendment to section 633(e) which would add an additional transitional rule to the eight already included in the Act. The effect of this amendment would be to retain the benefits of the General Utilities Rule in regards to the liquidation of a corporation by a particular estate and subsequent distribution of the assets to cancer research. We plan that the amendment will be designed to apply to this singular instance exclusively.

Some 15 years ago, our client began a program under which he has dedicated substantially all of his estate to the understanding and eradication of cancer. Because he viewed malignant disease as a worldwide challenge, his first major step in 1974 and 1975 was the organization of a foreign institute for cancer research which he endowed with foreign assets. The institute has a multi-million dollar annual research budget. It operates through branches in affiliation with university hospitals located in Australia, Belgium, Brazil, Canada, Great Britain, Sweden and Switzerland. Its work involves both clinical and laboratory research related to cancer. It is looked upon as one of the outstanding cancer research institutes in the world.

Our client's will, which for other reasons cannot now be changed, establishes a domestic institute which is even now being looked upon with great anticipation by leading cancer research scientists. The institute will hold all, except a nominal amount, of our client's estate for the support of cancer research by a designated group of leading medical research and teaching institutions in the United States. To help provide the endowment for this trust, it will be necessary for his estate, upon his death, to liquidate a domestic real estate holding company that has been in existence for many years. Prior to the effective date of the Tax Reform Act of 1986, this liquidation would have been accomplished without tax not only at the estate or trust level, but also at the holding company level. Because of the repeal of the *General Utilities Rule* by the Tax Reform Act of 1986, however, the endowment of the charitable trust will be reduced by many millions of dollars because of the tax to be levied against the real estate holding company when its assets are liquidated. Obviously, this kind of result could not have been an intended result by the drafters of the Act.

We are submitting this letter in order to comply with the Committee's request that comments be submitted by July 17.

Very truly yours,

RAGAN & MASON

William F. Ragan

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July 16, 1987

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Washington, DC 20515

RE: Written Comments on H.R. 2636, The Technical Corrections Act of 1987

Dear Mr. Leonard:

I am writing to pass on comments related to Section 106(f)(5) of H.R. 2636, and certain implications contained in this section.

Section 106(f)(5) of H.R. 2636 codifies the fact that certain items of income attributable to periods before the first taxable year in which the corporation was an S corporation shall be treated as built-in gains for Section 1374 of the Internal Revenue Code. The explanation of this provision indicates that the term "disposition of any asset" includes not only sales or exchanges but other income recognition events that effectively dispose of or relinquish a taxpayer's right to claim or receive income. The explanation includes examples specifying the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting.

Under Section 1374 of the Internal Revenue Code, any such built-in gains resulting from conversion from C corporate status to S corporate status would be taxed at the highest corporate tax rate. We strongly recommend that the regular graduated corporate rates, rather than a flat corporate rate at the highest level, be applied to recognized built-in gains of "qualified corporations", as defined under Section 633(d)(5) of the 1986 Tax Reform Act. This provision would give smaller corporations consistent treatment regarding the taxation of these items which they would have received had they retained C corporate status.

We sincerely thank you for your attention to this matter.

Sincerely,

Robert J. Ranweiler

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July 6, 1987

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RE: Tax Reform Act of 1986 (P.L. 99-514) Section 633(d); Technical Corrections Bill of 1987 (H.R. 2636 and S. 1350) Section 106(g)(5)-(6)

Dear Mr. Leonard:

Pursuant to House Ways and Means Committee Chairman Dan Rostenkowski's invitation to examine and comment on the Technical Corrections Bill of 1987, which was introduced by Chairman Rostenkowski on June 10, 1987 as H.R. 2636 and by Senate Finance Committee Chairman Lloyd Bentsen as S. 1350, we submit the following written statement in support of delaying the effective date of the 5-year stock holding requirement of the special transitional rule provided for certain closely held liquidating corporations until June 10, 1987 (the date on which H. R. 2636 and S. 1350 were introduced).

Prior Law

Under prior (as well as present) law, corporate earnings from sales of appreciated property were generally taxed twice, first to the corporation when the sale occurred, and again to the shareholders when the net proceeds were distributed as dividends. If the income to the corporation resulted from the sale of inventory or other ordinary income assets, the income was taxed to the corporation at ordinary rates. If the income resulted from the sale by the corporation of a capital asset held by it for more than 6 months, the income was taxable at capital gains rates. With certain exceptions, shareholders were taxed at ordinary income rates to the extent of their pro rata share of the distributing corporation's current and accumulated earnings and profits.

An important exception to the general rule discussed above generally permitted the non-recognition of gain by corporations on certain liquidating sales of corporate property and on certain distributions to shareholders of appreciated property.[1] The exception, commonly known as the "General Utilities doctrine," is based upon General Utilities and Operating Co. v.

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[1] The term "appreciated property" as used herein refers to property whose fair market value or sales price exceeds its adjusted basis in the hands of the transferor corporation.

Helvering.[2] Although the General Utilities case involved a dividend distribution of appreciated property by an ongoing business, the term "General Utilities rule" is often used in a broader sense to refer to the non-recognition treatment accorded in certain situations to liquidating as well as non-liquidating distributions to shareholders and to liquidating sales.

The General Utilities doctrine was reviewed by Congress and codified in Section 337 of the 1954 revision of the Internal Revenue Code of 1954 (hereinafter referred to as the "1954 Code"). Section 337 provided that if a corporation adopted a plan of complete liquidation and within 12 months of the adoption of the plan of liquidation distributed all of its assets in complete liquidation, gain or loss on any sales by the corporation during that period generally was not recognized by the corporation. Excepted from the Section 337 non-recognition provisions were sales of inventory (other than inventory sold in bulk), stock in trade, and property held primarily for sale to customers in the ordinary course of business. In addition, if a liquidating corporation accounted for its inventory on a LIFO basis, Section 337 required the amount of any LIFO recapture to be included in the corporation's income.

Present Law

The Tax Reform Act of 1986[3] (hereinafter referred to as the "Act"), provides that gain or loss is generally recognized by a corporation on a liquidating distribution of its assets as if the corporation had sold its assets to the distributee at fair market value. The distributee/shareholder is also subject to tax to the extent that the fair market value of the assets distributed exceeds the basis of the shareholder's stock in the liquidating corporation.

Although the repeal of the General Utilities rule is generally effective for liquidating sales and distributions after July 31, 1986, the Act provides a number of general transitional rules, some of which are based on actions before November 20, 1985 (the date of action by the House Ways and Means Committee), on actions before August 1, 1986 (the date of action by the Conference Committee), and on actions after July 31, 1986 and before January 1, 1987. With certain exceptions (i.e., depreciation recapture, investment tax credit recapture, ordinary gains or losses, gains from installment sales, gains or losses on capital assets held for less than six months, etc.) amendments made by the Act, including the repeal of the General Utilities rule and Section 337 of the 1954 Code, are inapplicable to transactions covered by the general transitional rules.

In addition to the general transitional rules, the Act specifically provides for a special transitional rule for certain small corporations.[4] Section 633(d) of the Act generally provides that in the case of the complete liquidation of a corporation on or before January 1, 1989, the amendments made by the Act concerning the recognition of gain by a corporation on a liquidating distribution of its assets will not apply if the liquidating corporation is a "qualified corporation." The term "qualified corporation" is defined by Section 633(d)(5) as any corporation if -

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[2] General Utilities and Operating Co. v. Helvering Property, 296 U.S. 200 (1935).

[3] Tax Reform Act of 1986, P.L. 99-514.

[4] Section 633(d) of the Tax Reform Act of 1986, P.L. 99-514.

(A) On August 1, 1986, and at all times thereafter before the corporation is completely liquidated, more than 50 percent (by value) of the stock in such corporation is held by 10 or fewer qualified persons, and

(B) The applicable value of such corporation does not exceed $10,000,000.

The term "qualified person" means an individual, estate or any trust described in Section 1361(c)(2)(A)(ii) or (iii) of the Internal Revenue Code of 1986 (hereinafter referred to as the "Code").

As enacted and as cited above, the definition of a qualified corporation as codified in Section 633(d)(5) does not include or require that more than 50 percent (by value) of the stock in such corporation be held by ten or fewer qualified persons who have held their stock for a period of 5 years or longer.

Proposed Technical Correction Amendment

As proposed, Section 106(g)(5) of the Technical Corrections Bill of 1987[5] (hereinafter referred to as the "Bill") amends Section 633(d)(5) of the Act by deleting the words "10 or fewer qualified persons" and inserting in lieu thereof the phrase "a qualified group". Subsection 6 of Section 106(g) of the Bill provides the following definitions of the terms "qualified group" and "qualified person."

> (A) QUALIFIED GROUP. - The term "qualified group" means any group of 10 or fewer qualified persons who at all times during the 5-year period ending on the date of the adoption of the plan of complete liquidation (or, if shorter, the period during which the corporation or any predecessor was in existence) owned (or was treated as owning under the rules of subparagraph (C)) more than fifty percent (by value) of the stock in such corporation.
>
> (B) QUALIFIED PERSON. - The term "qualified person" means -
>
> (i) An individual,
>
> (ii) An estate, or
>
> (iii) Any trust described in clause (ii) or clause (iii) of Section 1361(c)(2)(A) of the Internal Revenue Code of 1986.

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[5] Technical Corrections Bill of 1987, introduced June 10 as H.R. 2636 and S. 1350.

Section 119 of the Bill concerning the effective date of the technical corrections provides that "Except as otherwise provided in this title, any amendment made by this title shall take effect as if included in the provision of the Reform Act to which such amendment relates."

Detrimental Impact of Retroactive Amendment to Transitional Rule for Certain Small Corporations - Act Section 633(d)

In March of 1987 SP Energy Development Company, a limited partnership organized under the laws of the State of Washington and on whose behalf this statement is submitted (hereinafter referred to as "Spedco"), commenced negotiations with the sole shareholder of a group of small, related Oklahoma oil and gas corporations to acquire the assets of those corporations. Subsequently, in May of 1987, those Oklahoma oil and gas corporations adopted a plan of complete liquidation in reliance upon the transitional relief provided by Act Section 633(d). Pursuant to that transitional rule, the oil and gas corporations which were qualified corporations within the meaning of Act Section 633(d), were entitled to avail themselves of the Section 337 liquidation election provided under the Internal Revenue Code of 1954. In May of 1987, SPEDCO agreed to purchase all assets and assume all liabilities of the liquidating corporations for an aggregate purchase price of $1,500,000. The transaction was closed on June 5, 1987 and pursuant to the escrow instructions, all assets and proceeds were distributed at that time.

At all times during the negotiations and at the time of the adoption and actual liquidation of the corporations, the corporations were qualified corporations within the meaning of Act Section 633(d)(5) as enacted (i.e., on August 1, 1986 and at all times until the corporations were completely liquidated, all of the stock of such corporations was owned by one individual and the applicable value of each corporation did not exceed $5,000,000.)

As noted previously, current law as promulgated by Section 633(d) of the Act makes no reference to the Congressional Conference Committee Report requirement that a corporation will be eligible for the transitional rule only if its stock does not exceed $10,000,000 and more than 50% of its stock is owned by ten or fewer individuals who have held their stock for five years or longer. H. Rep. 99-841, Volume II, Page 206.

Where the meaning of a statute is clear and unambiguous on its face, it is a well-established principle that the statute should be interpreted literally and its legislative history should not be resorted to. Patagonia Corp. v. Bd. of Governors of Fed. Reserve Syst., 517 F.2d 803 (9th Cir. 1975); In re Parkwood, Inc., 461 F.2d 158 (D.C. Cir. 1971); C.I.R. v. Ridgeway's Est., 291 F.2d 257 (3rd Cir. 1961). The proper function of legislative history is to resolve ambiguity and not to create it.

> Where doubts exist and construction is permissible, reports of the committees of Congress and statements by those in charge of the measure and other like extraneous matter may be taken into consideration to aid in the ascertainment of the true legislative intent. But where the language of the enactment is clear, and construction according to its terms does

> not lead to absurd or impracticable consequences, the words employed are to be taken as the final expression of the meaning intended. And in such cases, legislative history may not be used to support a construction that adds to or takes from the significance of the words employed. (Emphasis Added).

U.S. v. Missouri Pac. R. Co., 278 U.S. 269, 278, 49 S. Ct. 133, 136 (1929).

Moreover, it has been held that an intentional omission of a word from a statute constitutes evidence that Congress did not intend to grant the power which the inclusion of the word or words omitted may have given. Shell Oil Co. v. Fed. Energy Admin., 400 F. Supp. 964 (D.C. Tex. 1975), aff'd. 527 F.2d 1243 (Temp. Emer. Ct. App. 1975).

On December 31, 1986, the Internal Revenue Service issued guidance in the form of Revenue Ruling 87-4, I.R.B. 1987-2, relating to the applicability of the transitional rule provided under Section 633(d) of the Act to complete corporate liquidations under Section 333 of the 1954 Code. The Internal Revenue Service determined that the language of the transitional rule for qualified corporations extended transitional relief not only to corporate-level gain under Section 337 corporate liquidations, but also with respect to gain which would otherwise be recognized at the shareholder-level as a result of a Section 333 liquidation. In reaching that determination, the Service reviewed the Section 633(d) transitional rule and specifically noted the following:

> Section 633(d)(5) of the Act generally defines "qualified corporation" as any corporation of which more than 50 percent (by value of the stock is held by 10 or fewer "qualified persons," as defined in Section 633(d)(6) and the applicable value of which does not exceed $10,000,000.

As noted previously, Section 633(d)(6) of the Act defines a qualified person as an individual, estate, or certain trusts.

Thus, not only did Spedco rely upon the definitions contained within the law as it existed at the time of the transaction and as it exists at present time, but so did the Internal Revenue Service in issuing its interpretation of the applicability of the transitional rule to certain qualified liquidating corporations. Based upon the transitional rule as promulgated in Section 633(d) of the Tax Reform Act of 1986, the cases cited above concerning statutory construction and interpretation, and the fact that the Internal Revenue Service relied upon the current definition of the term "qualified corporation" when it issued Revenue Ruling 87-4, Spedco, the selling Oklahoma oil/gas companies and similarly situated liquidating qualified corporations should be entitled to rely on the law as it currently exists.

In the event that Sections 633(d)(5) and (6) of the Act are retroactively amended to require a 5-year holding requirement by enactment of Section 106(g)(6)(A) of the Bill, Spedco's effective costs to purchase the assets of the Oklahoma corporations will be increased by approximately $400,000. Such additional cost will cause Spedco irreparable harm.

Section 106(g)(6)(A) of the Technical Corrections Bill of 1987, H.R. 2636 and S. 1350 states as follows:

> "(A) QUALIFIED GROUP. - The term 'qualified group' means any group of 10 or fewer qualified person who at all times during the 5-year period ending on the date of adoption of the plan of complete liquidation (or, if shorter, the period during which the corporation or any predecessor was in existence) owned (or was treated as owning under the rules of subparagraph (C)) more than 50 percent (by value) of the stock in such corporation."

The following amendment to Section 106(g)(6)(A) of the Technical Corrections Bill of 1987, H.R. 2636 and S. 1350 is proposed:

> "Subparagraph (A) of Section 106(g)(6)(A) of the Technical Corrections to the Tax Reform Act of 1986 is amended by adding at the end thereof the following sentence:
>
> > For the purposes of the preceding sentence, the requirement that more than 50 percent (by value) of the stock in such corporation be owned (or treated as owned) at all times during the 5-year period ending on the date of the adoption of the plan of complete liquidation (or, if shorter, the period during which the corporation or any predecessor was in existence) shall not apply if such corporation adopted a plan of complete liquidation prior to the date of enactment of this Act.

Revenue Effect

The Staff of the Joint Committee on Taxation estimated that the provisions requiring the recognition of gain or loss on liquidating sales and distributions (i.e., the repeal of the General Utilities doctrine) (Sections 631, 632 and 633 of the Act and Sections 336, 337 and 1374 of the 1954 Code) will increase fiscal year budget receipts by $15 million in 1987, $180 million in 1988, $348 million in 1989, $460 million in 1990 and $551 million in 1991.[6]

The amendment we recommend would have a revenue impact only during a part of fiscal year 1987. It would apply only to the very limited number of completed transactions where otherwise qualifying stockholders had not owned their stock for at least 5 years. There would be a very minimal effect on fiscal year 1987 budget receipts, and no revenue impact thereafter.

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[6] General Explanation of the Tax Reform Act of 1986 as prepared by the staff of the Joint Committee on Taxation, May 4, 1987.

To alleviate the irreparable harm and inequity which will be caused by the retroactive enactment of a 5-year holding requirement to the special transitional rule for certain small corporations provided by Section 633(d) of the Act, we respectfully request that the applicability of the 5-year holding requirement of Section 106(g)(6)(A) of the proposed Bill be delayed until June 10, 1987 (the date on which H.R. 2636 and S. 1350 were introduced).

Should you have any questions or require any additional information concerning this issue, please do not hesitate to contact the undersigned or any of the persons listed in Exhibit A attached hereto. Your time and careful consideration of this matter is most appreciated.

Respectfully submitted,

HARRIS, MERICLE & ORR

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July 8, 1987

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Ms. Laura Wilcox
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Re: Section 106(g)(5) of the
Technical Corrections Act of 1987

Dear Mr. Leonard and Ms. Wilcox:

I am involved in a situation whereby the enactment of Section 106(g)(5) of the TCA would cause a corporation which is now a "qualified corporation" under Section 633(d)(5) of the 1986 Act to cease to be a "qualified corporation." While I appreciate that the Conference Committee may perhaps be said to have intended this result, I am not convinced that it did, or that such a result is appropriate under the circumstances of this particular corporation's situation.

From 1953 to June 6, 1986 there were two 50% shareholders in the corporation. On that day the stock of one shareholder, then over 75 years of age, was completely redeemed for $1.5 million. Consequently, the second shareholder's ownership of the corporation's stock increased to 100% on, and has remained at 100% since, June 6, 1986, which of course would include August 1, 1986, a key date under Section 633(d)(5)(A) of the 1986 Act. The value of the 100% stock interest owned by the second shareholder, who is now over 70 years of age, has not been in excess of $2.2 million since August 1, 1986.

Under Section 633(d)(5) of the 1986 Act the corporation is now a "qualified corporation," because its sole shareholder has owned "more than" 50% of its stock since August 1, 1986, and the stock's value is less than $10 million. However, under Section 633(d)(5)(A) and (6)(A) of the 1986 Act, if amended by Section 106(g)(5)(A) and (B) of the TCA, the corporation would not be a "qualified corporation," because its sole shareholder has not owned "more than" 50% of its stock for five years; he has owned it for only 13 months.

Until the introduction of the Technical Corrections Act the corporation was negotiating the sale of its business with one buyer and the sale of its building with a second buyer. These negotiations have now been terminated solely as a result of the introduction of the TCA.

The June 6, 1986 action which disqualified the corporation, a redemption of 50% of its stock, was action which, indeed, made the corporation "smaller" based on the two criteria contained in Section 633(d)(5) of the 1986 Act: The number of its shareholders and its value. The corporation went from having two shareholders to having one shareholder, and its value decreased from $3.7 million to $2.2 million (a value which would entitle it to the *full* benefits of the transitional rule). Furthermore, on June 6, 1986 neither the House nor the Senate had devised any such transitional rule. Thus, there was no reason at that time to redeem less than all of the stock of the redeemed shareholder, action which would have avoided the adverse consequences of Section 106(g)(5)(B) of the TCA.

Furthermore, based on the Conference Committee's September 1986 description of the unenacted five-year rule, the corporation had reason to believe from that time until last month that it would be a "qualified corporation" even if a five-year rule were enacted. In this regard, the Conference Committee stated:

> "A corporation is eligible for this [transitional] rule if ... more than 50 percent of its stock *is* owned by 10 or fewer individuals who have owned *their stock* for five years or longer." [Emphasis added.]

More than 50% of the corporation's stock *is* (was) owned by a single shareholder (on August 1, 1986) who has owned *their* (his) stock (albeit not *all* of his stock) for over 30 years. Thus, the Conference Committee's language may be read to suggest that the Committee did not intend to go as far as unenacted H. Con. Res. 395 went in stating that qualified persons must have held "such stock" (*i.e.*, more than 50%) for five years.

The result of Section 106(g)(5)(B) of the TCA could be reversed in the case of this corporation by a simple change: The language of Section 633(d)(6)(A) of the 1986 Act, as amended by Section 106(g)(5)(B) of the TCA, could refer to "50 percent or more" rather than "more than 50 percent."

Naturally, I have no idea as to the number of other corporations which would be similarly benefited by this change. However, most if not all of such corporations are probably "qualified corporations" under Section 633(d)(5) of the 1986 Act, and they would only be back where, based on the legislative language, they thought they were in the first place.

It is respectfully submitted that the language of Section 106(g)(5)(B) of the TCA penalizes a corporation which may indeed have been intended by the Conference Committee to be entitled to the "Transitional Rule for Certain Small Corporations," *is* clearly entitled to that rule under Section 633(d)(5) of the 1986 Act as enacted, and should not be retroactively denied the benefits of that rule more than seven months after enactment: A one-shareholder corporation with minimal value, in which the one shareholder (1) owned more than 50% of its stock on August 1, 1986, and (2) owned not less than 50% of its stock for more than 30 years.

Although this calendar year corporation elected status as an S corporation in December 1986, thereby permitting it to avoid the double tax created by repeal of the *General Utilities* doctrine by simply postponing the sale of its business and building to 1990, its 70-plus year old shareholder finds it difficult to understand why his corporation should no longer be a "qualified corporation." In effect, the TCA requires him to postpone the corporation's proposed sales for more than two years, or attempt to locate a purchaser of his stock. This shareholder is not assuaged by the knowledge that his corporation, by electing S corporation status in 1986 rather than now, has avoided the more severe ten-year waiting period applicable to late-electors.

The change suggested above to Section 106(g)(5)(B) would reverse what is considered by the shareholder to be not only an extremely unfair result, but much more than a "technical correction."

Very truly yours,

Martin A. Stoll

Section 653

Fidelity Investments

Robert C Pozen
Senior Vice President
General Counsel

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July 17, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am writing this letter to you to express the concerns of Fidelity Investments over certain of the changes to Internal Revenue Code ("Code") Section 851(b)(3) which are contained in the Technical Corrections Act of 1987 - H.R. 2636 and S.1350 ("the Act").

Fidelity Investments is a diversified financial services business which at present is the manager of regulated investment companies (RICs) and other accounts for over 3 million investors with over $80 billion under management.

The Short-Short Gain Test

Section 851(b)(3) of the Code provides one of the requirements which a corporation must meet in order to be treated as a RIC. At present, it provides that a corporation will not be eligible for the pass-thru treatment afforded RICs under Subchapter M unless less than 30 percent of its gross income is derived from the sale or other disposition of stock or securities held for less than three months. Such nonqualifying gain is generally referred to as "short-short gain" or "short three gain". It has been stated that the purpose of the short-short gain rule is to prevent the portfolio managers of RICs from churning the portfolios.

The Expanded Definition of Short-Short Gain

Section 106(n)(2) of the Act would amend Section 851(b)(3) to provide that short-short gain would include, in addition to gain from stocks and securities, gain from foreign currencies (except as provided in regulations), options, futures and forward contracts held for less than three months. Our concerns principally relate to the application of this expanded definition of the Act to those RICs which invest primarily in securities of foreign issuers, the purchase and sale of which are denominated in currencies other than the U.S. dollar.

Procedural Considerations

We believe that the expansion of the Section 851(b)(3) test by Section 106(n)(2) of the Act to include gain from investments which are not stock or securities is not a correction of the Tax Reform Act of 1986 but rather is a significant modification and expansion of its provisions. We believe that such substantive changes should not be part of the technical correction effort which is currently being undertaken. Rather such changes should only be considered as part of future legislation.

As presently drafted, the Section 851(b)(3) changes would be retroactive in their application to taxable years beginning after the date of enactment of the Tax Reform Act of 1986 - October 22, 1986. Such retroactive application could result in disqualification of many RICs for pass-thru treatment under Subchapter M of the Code. Relying on Section 851(b)(3) as presently constituted, RIC's may have realized substantial gains from transactions in foreign currencies. If enacted, the proposed change could result in such gains being retroactively recharacterized as short-short gains. These funds may now find it virtually impossible to maintain qualification as a RIC for their current fiscal year - a result solely attributable to this retroactive application of the change.

It is our view that it is not sound tax policy nor would it be fair to RIC shareholders to retroactively apply such substantive changes to Section 851(b)(3) as those proposed by Section 106(n)(2) of the Act. Therefore, if these changes are adopted as part of the Act, they should be effective for tax years of RICs beginning after the date of enactment of the Act.

Business of Investing Exceptions

In the event that a modification of the short-short test is deemed to be necessary, we believe that an exception should be provided for certain gains from foreign currencies and gains from options, futures and forward contracts related to foreign currencies. We recommend that such gains, to the extent that they are related to a RIC's business of investing in stocks or securities, be excepted from the short-short test.

Congress clearly recognized that such business related income should be considered qualifying income for purposes of Section 851(b)(2) when it passed the Tax Reform Act of 1986. Section 653(b) and (c) of the Tax Reform Act of 1986 expanded the definition of qualifying income to include, in addition to dividends, interest, income from security lending and gains from stock and securities transactions:

- other income including gains from options, futures and forward contracts derived with respect to its business of investing in stock or securities, and
- gains from foreign currency except to the extent determined under regulations to be not directly ancillary to a RIC's business of investing in stock or securities

We believe that Congress should expressly establish similar exceptions to the short-short rule for gains from foreign currencies and foreign currency related options, futures and forward contracts. We recognize that Section 106(n)(2) of the Act does provide Treasury with regulatory authority to except foreign currency transactions from the short-short rule. However, we believe that such an exception is so important that it should be contained in the Act itself and should not be delayed unless and until Treasury issues appropriate regulations.

In any event, Section 106(n)(2) does not provide Treasury with regulatory authority to except from the short-short rule gains from options, futures and financial contracts in foreign currencies. The use of such derivative instruments is is often a more efficient and effective method of minimizing exposure to foreign currency fluctuations than by buying and selling the actual currency. As a result, we advocate that the exception apply to such instruments as well as foreign currencies.

The proposed expansion of the short-short test without the business of investing exceptions could require a corporation to take undue speculative risk in the foreign currency markets so as to meet the short-short test and maintain its RIC status. This is clearly inconsistent with the stated purpose of Section 851(b)(3).

Regulatory Issues

In the event that the expansion of the short-short test is adopted without the statutory exceptions described immediately above (i.e., the business of investing exceptions), we believe that new Section 851(b)(3)(B) should provide the Secretary with regulatory authority to make exceptions for gains from options, futures and forward contracts relating to foreign currencies as well as transactions in foreign currencies.

We believe that Congress should make it clear that these regulations should provide a broad ancillary business exception for gains from foreign currency and for related options, futures and forward contracts. For example, exceptions should be provided for gains from temporary foreign currency holdings, and gains resulting from settlement of security purchases and sales and related options, futures and forward contracts.

In a related matter, Section 851(g) provides, in certain circumstances, a RIC with the ability to net gains and losses on hedged positions for short-short gain purposes. It appears that hedging transactions utilizing futures or forward contracts may not qualify for this netting treatment unless specifically provided for under regulations to be issued pursuant to Section 851(g)(2)(A)(iii). We believe that futures and forward contracts, being standard hedging instruments, are eligible for Section 851(g) netting treatment. However, to eliminate potential uncertainty in this area Congress should confirm that futures and forward contracts are to be included in the definition of "other positions" as used in Section 851(g)(2)(A)(iii).

Treatment of Section 988 Gains

Almost all of the above described transactions, except for those involving Section 1256 contracts, also are considered transactions under Section 988 of the Code. Therefore, as an alternative approach, Congress could enact appropriate relief for short-short gains in connection with Section 988 transactions, while providing the above described regulatory exceptions for all transactions not covered by such legislative relief.

RICs which invest in foreign currency denominated securities can generate gain from Section 988 transactions as defined in Section 988(c) of the Code. All or a part of such gain may constitute foreign currency gain as defined in Section 988(b) of the Code. Such foreign currency gain or loss attributable to a Section 988 transaction is generally treated as ordinary income under Section 988(a)(1)(A) of the Code To the extent provided in regulations, such ordinary income or loss is to be treated as interest income or expense for certain purposes.

It is our view that the Act should be amended to specifically provide that for purposes of Section 851(b)(3) of the Code that all foreign currency gain or loss from a Section 988 transaction should be considered as interest income or interest expense. The basic rationale behind Section 988 is that there is a direct relationship between the movement of foreign exchange rates and interest rates. In fact, the House of Representatives version of Section 988 specifically treated foreign currency gains and losses as interest income and interest expense. However, the Tax Reform Act of 1986 in the final version left such interest characterization to regulatory authority.

If blanket treatment of Section 988 foreign currency gains and losses as interest income and expense is not adopted, it is our view that as a minimum certain specific gain or loss transactions should be given such interest characterization.

Specifically, interest treatment should be provided for:

- gain or loss attributable to the disposition of an investment by a RIC in a foreign currency which was held pending the purchase of a foreign security;
- gain or loss attributable to interest or dividends receivable which are payable in a foreign currency;
- gain or loss attributable to the sale or disposition of a debt instrument;
- gain or loss attributable to the disposition of forward contracts (which are not Section 1256 contracts) relating to foreign currencies.

It is our view that such treatment is consistent with the rationale behind Section 988. Moreover, it would be inconsistent with the objectives of Section 851(b)(3) to jeopardize a RIC's status as a result of gains which could arise from such purely passive non-speculative investment activities.

If you wish to discuss any of these matters further, or have any questions regarding them, please do not hesitate to call me.

Sincerely,

Robert C. Pozen

Robert C. Pozen

COMMENTS OF FMR CORPORATION RELATING TO PROPOSED TECHNICAL CORRECTION TO THE "SHORT-SHORT" RULE OF CODE SECTION 851(b)(3)

Summary

These comments describe the need for, as well as the basic elements of, a proposed technical correction that would modify the "short-short" rule of Code section 851(b)(3) in cases where regulated investment companies experience significant net redemptions. In such cases, fund managers are required to convert securities to cash and risk violation of the short-short rule. The proposed technical correction would alleviate this problem by allowing a limited amount of gains from the sale or other disposition of securities held for less than three months to be disregarded for purposes of the short-short rule in circumstances where regulated investment companies experience substantial net redemptions.

Background

Section 851(b)(3) of the Internal Revenue Code ("Code") provides that, in order to qualify for pass-through treatment, a regulated investment company ("RIC") must derive less than 30 per cent of its gross income from the sale or other disposition of stock or securities held for less than three months. This requirement is commonly called the "short-short" rule.

Section 654 of the Tax Reform Act of 1986 ("1986 Act") requires a series mutual fund, composed of several portfolios, to treat each portfolio as a separate RIC for all tax purposes (including application of the short-short rule). Before the 1986 Act, some series funds applied the short-short rule on a fund basis while others applied the rule to each portfolio. In resolving this disparity of treatment, Congress did not address the relationship between a short-short rule based on each portfolio and the level of redemptions experienced by each portfolio.

The Conference Report to the 1986 Act indicates that the conferees retained the short-short rule as an "appropriate requirement" to ensure that RICs are "passive" entities. H.R. Rep. 99-841 at II-245. While the legislative history at the time of the inception of the short-short rule in 1936 sheds no light on its purpose, the Internal Revenue Service has viewed the rule as intended to prevent RIC managers from engaging in excessive short-term trading to the detriment of RIC shareholders. See, e.g., Revenue Ruling 75-376. This rationale simply does not apply to net redemption situations where a RIC manager must convert securities to cash in response to the investment decisions of some RIC shareholders over which the RIC manager has no control.

Problem

An individual portfolio can experience significant daily changes in the level of redemption requests, including redemptions resulting from exchanges between two portfolios in the same mutual fund. In order to satisfy substantial net redemptions--where more shares of a portfolio are redeemed than purchased by investors--a portfolio manager must convert substantial amounts of securities held by the portfolio into cash. Unless the short-short rule is amended, portfolio managers will be forced to base these investment decisions on tax considerations to the detriment of portfolio shareholders.

In order to cope with net redemptions and comply with the short-short rule, portfolio managers will be forced to sell long-term securities, hold short-term securities, or take other actions that may be contrary to their best investment judgment. If periods of heavy net purchases are followed immediately by period of heavy net redemptions, a portfolio manager can even be forced to sell short-term securities and jeopardize the qualification of the portfolio for pass-through tax treatment. For example, one actual portfolio in 1986 had net assets of $9 million on May 20, $40 million on July 8, and $16 million on July 18. In order to pay shareholders redeeming between July 8 and July 19, the portfolio had to sell a large block of securities held for less than three months.

The short-short rule has always impeded RIC managers from responding to market conditions and the results of investment analysis in coping with net redemptions. By putting the short-short rule on a portfolio by portfolio basis, Congress exacerbated the problem posed by this rule in two important ways for RIC managers previously operating on a fund basis in coping with net redemptions.

First, a portfolio in a series mutual fund is obviously much smaller than the fund itself. A small RIC is more vulnerable than a large RIC to net redemption pressures because in a small RIC a dramatic increase in net redemptions can be caused by the withdrawal of only a few large shareholders on the same day. For example, in a portfolio with only $50 million in assets, a portfolio manager can be faced with a potential crisis if two shareholders each redeem $1 million on the same day, although the series fund as a whole may have $500 million in assets.

Second, with a short-short rule based on each portfolio, the RIC manager can become vulnerable to net redemption pressures caused by exchanges between two portfolios in the same mutual fund. Such an exchange is accomplished by a redemption of shares in one portfolio and a simultaneous purchase in another portfolio. As a result, a manager of a portfolio with $50 million in assets can be faced with a potential crisis if two shareholders each merely transfer $1 million from this portfolio to another portfolio in the same series fund, although the total assets of such fund remain exactly the same.

In light of the above, Section 851(b)(3) should be amended to provide relief from application of the short-short rule in the case of certain gains attributable to net redemptions. By correcting this problematic effect of the 1986 Act, Congress would help small and start-up RICs, as well as series mutual funds, to comply with the short-short rule. Congress would also be adjusting the short-short rule to allow investors to enjoy a wider range of choice through exchanges between portfolios.

Explanation

The proposed technical amendment would add a new subsection (h) to Code section 851. The amendment is modeled after subsection (g), added by the 1986 Act, concerning designated hedges. Thus, any gain which comes within the scope of subsection (h) would be excluded from both the numerator and the denominator of the fraction called for by section 851(b)(3).

The amendment provides that certain gains derived during a specified period are disregarded for purposes of Section 851(b)(3). The period begins on the day after a RIC experiences daily net redemptions in excess of 1% of its net asset value and ends when net investments in the RIC are sufficient to counterbalance the net redemptions experienced on the trigger date. The gains disregarded for purposes of section 851(b)(3) would be limited by the amount of sales proceeds needed to satisfy the net redemptions. Other elements of this proposed amendment have been considered in discussions between staff and representatives of FMR Corporation.

In sum, the proposed technical correction would enable a fund manager to respond to significant net redemptions without jeopardizing the status of the RIC.

* * * * *

July 17, 1987

Re: Treatment of Foreign Currency Gains for Purposes of Section 851(b)(3) of the Internal Revenue Code (Section 106(n)(2) of the Technical Corrections Act of 1987)

This memorandum discusses Section 106(n)(2) of the Technical Corrections Act of 1987 (the "Act"), which would modify the 30% of gross income requirement applicable to regulated investment companies.

Section 851(b)(3) of the Internal Revenue Code of 1986 (the "Code") provides that a regulated investment company must derive less than 30% of its gross income from the sale or other disposition of stock or securities held less than 3 months (the so-called "short-short" rule).* The Internal Revenue Service has stated that the purpose of this requirement is "to ensure that regulated investment companies engage primarily in safeguarding investments and securing investment returns consistent with safety of principal" and to prevent regulated investment companies from "actively trading securities for the purpose of making short-term trading profits." Rev. Rul. 75-376, 1975-2 C.B. 267.**

Section 106(n)(2) of the Act would amend Section 851(b)(3) of the Code to provide that income taken into account for purposes of the short-short rule includes, among other types of income, gross income derived from the sale or disposition of options, futures or forward contracts held for less than 3 months and, except as may be provided in regulations, foreign currency held for less than 3 months.[*] That provision would apply retroactively to taxable years beginning after October 22, 1986.

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* For purposes of Section 851(b)(3) of the Code, losses from the sale or other disposition of stock or securities do not enter into the computation. Treas. Reg. § 1.851-2(b).

** The General Explanation of the Tax Reform Act of 1986 states on page 377 that the short-short requirement "is an appropriate requirement to ensure that a [regulated investment company] is a passive entity."

We view that provision of the Act, particularly as it relates to foreign currency, as problematic in several regards. First, while the provision applies to income from the sale or disposition of "foreign currency", no definition of "foreign currency" is provided. It is therefore unclear whether Section 106(n)(2) of the Act would include only income from the actual sale or disposition of nonfunctional currency,[**] or whether it would also apply to any "foreign currency gain" as defined in Section 988(b)(1) of the Code. If it is intended to apply to the latter, Section 106(n)(2) of the Act presumably would include foreign currency gains attributable to the 3 month period before any "payment date" (as that term is defined in Section 988(c) of the Code).

If Section 106(n)(2) of the Act is intended to apply to any "foreign currency gain" attributable to the 3 month period before a payment date, we believe it inappropriately sweeps into Section 851(b)(3) of the Code income which is wholly unrelated to the purpose of the short-short rule and represents a significant expansion of present law. For example, foreign currency gains attributable to exchange rate fluctuations between the trade date for the purchase of an instrument and the settlement date relating to that purchase may be counted for purposes of the short-short rule. Furthermore, foreign currency gains realized upon receiving principal payments on a foreign currency denominated debt instrument within 3 months of the instrument's acquisition (including principal payments on short-term debt instruments having maturities of less than 3 months) may be counted for purposes of the short-short rule. Similarly, foreign currency gains realized upon the receipt of interest payments on a foreign currency denominated bond (or the receipt of the redemption price on an instrument bearing original issue discount in foreign currency units) might also result in short-short income to the extent attributable to interest (or original issue discount) accrued during the 3 months prior to payment.

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[*] The explanation of the Act prepared by the Staff of the Joint Committee on Taxation states on page 56 that "the bill clarifies that the 30 percent test is applied with respect to sales or dispositions of . . ., options, futures or forward contracts; or, except as provided in regulations, foreign currencies."

[**] For purposes of computing a taxpayer's foreign currency gains and losses, Section 988(c) of the Code defines "nonfunctional currency" as including coin or currency as well as any nonfunctional currency denominated demand or time deposit or similar instruments issued by a bank or other financial institution. That definition therefore suggests that "foreign currency" for purposes of Section 106(n)(2) of the Act should be limited to coin or currency and demand or time deposits or similar instruments issued by a bank or other financial institution.

Such gains are attributable solely to exchange rate fluctuations, which are beyond the control of a regulated investment company, and do not create the "short-term trading profits" intended to be restricted by Section 851(b)(3) of the Code. We therefore believe that Section 106(n)(2) of the Act cannot be interpreted as applying to "foreign currency gains" as defined in Section 988(b)(1) of the Code.

Even if Section 106(n)(2) of the Act is interpreted as applying only to actual dispositions of non-functional currency, that provision represents a significant expansion of current law and, we believe, serves no useful purpose.

We recognize that regulations may limit the extent to which gains from the disposition of foreign currencies will be included for purposes of Section 851(b)(3) of the Code, but until such regulations are issued Section 106(n)(2) of the Act would, if enacted, create unwarranted uncertainty and confusion. That provision would also require regulated investment companies to establish burdensome bookkeeping systems to monitor the foreign currency gains taken into account for purposes of the short-short rule. Furthermore, because it applies retroactively, that provision has the potential for causing a corporation to fail to qualify as a regulated investment company because of transactions which the corporation had no reason to believe, at the time the transactions were completed, would give rise to income described in Section 851(b)(3) of the Code.

In view of the foregoing, we recommend that Section 106(n)(2) of the Act be modified to delete the provision relating to gains from foreign currency. The extent to which foreign currency gains should be included for purposes of the short-short rule is not an appropriate issue to be addressed in a technical corrections bill and cannot be addressed adequately by an amendment to the Code.

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FEDERAL EXPRESS

July 17, 1987

U.S. Senate Committee on Finance
Room 205, Senate Office Building
Washington, D. C. 20510

Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: H.R. 2636 and S. 1350 - Technical Corrections Act of 1987 (the "Act")

Ladies and Gentlemen:

The Putnam Management Company, Inc. ("Putnam") wishes to express its views on one issue being considered in your deliberations on the Act which is of vital concern to U.S. investors who invest in foreign securities and wish to protect their investment from unfavorable changes in the exchange rate between the U.S. dollar and the applicable foreign currency.

Putnam is an investment manager for 35 U.S. mutual funds with assets of over $32 billion owned by over 1.5 million shareholders. Putnam's affiliates manage approximately $10 billion of investments for institutional clients such as pension funds. Many of these mutual fund and pension clients invest in foreign equity or debt securities when consistent with their investment objectives as a means of obtaining greater diversification and enhancing their potential capital appreciation or income, as the case may be.

It is a customary and quite prudent practice for U.S. investors to assure a U.S. dollar value to the required payment on settlement of a securities purchase, and the value of the proceeds of a sale of securities or receipt of a dividend or interest payment on securities owned, by entering into a forward contract for the applicable foreign currency on U.S. dollars, as the case may be. Furthermore, the dollar value of foreign securities positions may be protected, or hedged, by appropriate forward currency contracts. In each case, this protects the U.S. investor from the currency risk in the investment resulting from changes in the relevant exchange rates.

This particular investment practice is not speculation. It is a conservative strategy intended to reduce the risk of loss to a U.S. investor whose economic frame of reference is the U.S. dollar.

Section 851(b)(3) of the Internal Revenue Code contains the so-called "short-short" requirement for U.S. mutual funds and requires that to be eligible for tax treatment as a regulated investment company the fund must derive less than 30% of its gross income from the sale or other disposition of stock and other securities.

We understand that Section 106(n)(2) of the Act would amend the short-short rule to include currency gains. Such a result would jeopardize the tax status of many funds investing in foreign securities for the very act of trying to protect the investment values of their U.S. shareholders. We do not believe that this is consistent with the apparent objective of Section 851(b)(3) to limit speculation and overly-aggressive trading. Indeed, to the extent that a fund was precluded from hedging against currency risk, it could be said to be assuming more speculative risk. We strongly urge your Committees to not enact any legislation that would inhibit mutual funds from seeking to reduce currency risk in foreign investing, either directly or indirectly via the short-short rule. There is no tax policy to be served by such a step, and it would be a disservice to U.S. investors.

Very truly yours,

Peter L. Curry
Senior Vice President and
Corporate Counsel

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Henry H. Hopkins
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July 17, 1987

Robert J. Leonard, Esquire
Chief Counsel
Committee On Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Leonard:

The purpose of this letter is to express the concern of T. Rowe Price Associates, Inc. ("Price Associates") regarding certain provisions of H.R. 2636, the Technical Corrections Act of 1987 ("the "Technical Corrections Bill"). If adopted, the Technical Corrections Bill will affect the tax treatment of many regulated investment companies and their shareholders. Briefly stated, this bill would significantly modify the requirement that a regulated investment company derive less than 30% of its gross income from the sale or other disposition of stock or securities held for less than three months. Section 851(b)(3) of the Internal Revenue Code of 1986 (the "Code") currently provides that a regulated investment company must derive less than 30% of its gross income from the sale or other disposition of stock or securities held for less than three months. This test is generally referred to as the "short-short rule". The stated purpose of the short-short rule is to prevent a regulated investment company from actively trading securities for the purpose of making short term trading profits. Despite industry efforts, supported by the Treasury Department, to have the short-short test repealed as part of the 1986 Act, the provision was unfortunately retained. There is currently pending a Bill (H.R. 2295) which would repeal the short-short rule.

The Technical Corrections Bill would substantially amend section 851(b)(3) to expand the types of property that would be covered by the short-short rule to include, among other things, gross income derived from the sale or other disposition of options, futures or forward contracts held for less than three months and, except as may be provided in regulations, foreign currency held for less than three months. If enacted in its current form, the Technical Corrections Bill would apply retroactively to taxable years beginning after October 22, 1986.

The scope of the above-cited provisions is at this time unclear. While the provisions apparently apply to income from the sale or disposition of "foreign currency" held for less than three months, a definition of "foreign currency" is not provided. Section 106(n)(2) of the Technical Corrections Bill appears to apply at a minimum to currency gains realized upon disposing of foreign coin or currency (for example, upon exchanging the foreign coin or currency into U.S. dollars or upon paying expenses with foreign coin, foreign currency denominated debt instruments or accruals of items of expenses or income in foreign currency units). If section 106(n)(2) of the Technical Corrections Bill were interpreted as applying to such transactions, foreign currency gains realized on a settlement date attributable to exchange rate fluctuations between the trade date and the settlement date, or upon the receipt of principal on a foreign currency denominated debt instrument within three months of the instrument's acquisition, (including principal payments on short-term debt instruments having maturities of less than three months) would be counted for purposes of the short-short rule. Similarly, foreign currency gains realized upon receipt of an interest payment on a foreign currency denominated bond, or upon receipt of the redemption price on an instrument bearing original issue discount in foreign currency units, might also result in short-short income to the extent attributable to interest (or foreign currency original issue discount) accrued during the three month period prior to the payment.

Furthermore, because section 106(n)(2) of the Technical Corrections Bill would also apply to the sale or disposition of futures and forward contracts held for less than three months, that provision may also apply to any foreign currency gains realized between the date the agreement was entered into to exchange one currency for another and the settlement date (typically two banking days later). We believe that section 106(n)(2) of the Technical Corrections Bill inappropriately includes for purposes of the short-short rule income wholly unrelated to the purpose of that rule. That provision causes particular concern because it would be applied retroactively. Although regulations may limit the extent to which foreign currency gains will be included for purposes of the short-short rule, it must be assumed that until such regulations are issued the provision will be applied to currency gains arising in a broad range of circumstances.

We believe that it is imperative that section 106(n)(2) of the Technical Corrections Bill be modified to delete the provision relating to foreign currency gains. If such action is not taken, certain investment companies will fail to qualify for Subchapter M treatment. From a tax policy point of view, there is no reason why an investment company should fail to qualify for Subchapter M treatment, and thus be subject to the full corporate level tax, as a result of foreign currency transactions that are ancillary to the investment company's business of investing in securities. This is true because (i) the investment company must buy and sell foreign currency in order to make (and liquidate) investments in foreign currency denominated stocks and securities, and (ii) as the Treasury has previously noted, it is appropriate for an investment company to use currency positions to hedge the currency risks associated with investments in foreign denominated stocks or securities. The ability to utilize such hedges to protect the value of an investment company's portfolio assets, as well as to reduce its exposure to currency fluctuation between the trade date and the settlement date on the purchase or sale of foreign stock and securities, is absolutely essential in light of the dramatic currency fluctuations that can and often do occur over very short periods of time.

We believe that the Treasury's authority to treat currency gains that are not ancillary to an investment company's business of investment in stock or securities as non-qualifying income under section 851(b)(2) is a sufficient "governor" to prevent inappropriate investments or speculation by investment companies in foreign currencies. If such gains are ancillary to the investment company's business of investment in stock or securities, there is no reason to disqualify an investment company from Subchapter M merely because the currency gains are derived in less than three months. If such gains are not so ancillary, they properly constitute non-qualifying income under section 851(b)(2) and may subject an investment company to disqualification under that provision.

Currency gains can arise under a variety of circumstances and, because of the nature of investments in foreign stock or securities, often arise during a very short time frame. For example, an investment company may sell a bond denominated in Deutschmarks and place the proceeds in a bank account with the expectation that it will use these funds to purchase another security shortly. A week later, the investment company may use these amounts to purchase another bond denominated in Deutschmarks, or, alternatively, may use the marks to purchase Swiss Francs which in turn will be used to purchase a bond denominated in Swiss Francs. During the week that the investment company is holding the Deutschmarks, they may appreciate significantly vis a vis the U.S. dollar. Surely this "currency gain" should not put the investment company at risk of losing its status under Subchapter M.

There are many other examples which could be cited. Subjecting these gains to section 851(b)(3) or attempting to delineate which types of currency gains must be taken into account for purposes of section 851(b)(3) and which types of currency gains are exempted, would create an impossible situation.

Price Associates cannot emphasize enough the seriousness of this matter and the adverse consequences that would ensue if the Technical Corrections Bill were allowed to pass in its present form. The arbitrary disqualification of legitimate investment companies will, of course, not only adversely impact such companies but also their shareholders.

If Congress determines it is necessary to expand the short-short rule to include certain foreign currency gains, any expansion must be implemented on a prospective basis only. A retroactive application of such a change to taxable years beginning after October 22, 1986 (the date of the enactment of the Code) will result in the disqualification of certain investment companies under Subchapter M without reasonable notice. The Code and its accompanying legislative history contain no indication that section 851(b)(3) would be expanded to cover foreign currency gains. Even the Joint Committee Explanation of the 1986 Act, which was released in May of this year, gives no indication that section 851(b)(3) would be so changed.

We appreciate the opportunity to comment on the Technical Corrections Bill and reiterate that we would be happy to discuss this matter with you at your convenience.

Sincerely,

T. ROWE PRICE ASSOCIATES, INC.

By: ______________________
Henry H. Hopkins
Director and Legal Counsel

Section 662

REALTY SOUTH
INVESTORS, INC.

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(404) 426-0327

July 15, 1987

Mr. Daniel Rostenkowski, III
U.S. Ways and Means Committee
1102 Longworth Office Building
Washington, DC 20515

RE: Technical Changes of Tax Reform Act of 1986

Dear Mr. Rostenkowski:

Included in the Tax Reform Act of 1986 were some portions dealing with REITs, the purpose for which were to clarify some portions of the current law and to remove some technical barriers which put REITs at a disadvantage when competing with other real estate investors. In general, all aspects of the bill were discussed with the REIT industry represented by NAREIT, located in Washington. However, one portion of the bill was not discussed with the industry and as it is written puts a great cloud over the entire operations of our company. This section (Subtitle G, Section 662, Paragraph (c): "Treatment of Shared Appreciation Mortgages") appears to have been drafted in haste and I'm sure is not intended to create the problems it could create.

I am President of Realty South Investors, Inc., a publicly traded (AMEX) corporation created in 1985 to invest in commercial real estate as a REIT through the participating mortgage vehicle. This is a vehicle that is fairly widely used in financing commercial real estate projects. As the lender on completed and leased projects we provide a fixed rate loan at a slightly lower interest rate than the current "market rate" and in return receive "contingent interest" by participating in any increases in rentals from the property and any increase in the value of the property upon sale of the property or the maturity of our loan. In keeping with the spirit of the REIT law we are a completely passive investor, taking no active involvement in the operation or marketing of the property. All of our documents are similar to those of other mortgage lenders.

This new section says that for REIT qualification only, (thus the borrower will continue to treat this as interest) the income we call "contingent interest" must be classified as "gain recognized on the sale of the secured property." It goes on to, in effect, put the REIT in the shoes of the owner of the property (our borrower) in determining whether the REIT meets certain REIT qualification tests. This creates two major problems for us: 1) income from gain on sale of properties is limited to 30% of gross income in order to qualify as a REIT, and 2) the REIT has no control over when a property sells, thus could potentially be classified as being active in real estate (a "dealer") if a combination of property sales and loan payoffs occur in the same year exceeds the safe harbor limit of seven sales and thus causing all such income to be taxed at a 100% rate.

I am advised that the purpose of this characterization as "gain" income was to prevent a REIT from becoming an "active" real estate investor. However, as pointed out earlier our investments are passive loans and in fact we are penalized under this new provision by not having any control by being active.

I know that any bills to change something for a specific industry are not popular due to the favored treatment image. However, since I'm sure that the change was not intended to create this problem, perhaps the bill to make technical corrections to the Tax Reform Act of 1986 is the place to make the correction to allow this income to classify as interest.

I'd appreciate your reviewing this problem and advising me if you agree that the "technical bill" is the place for correction.

Sincerely,

A.P. Chambliss, III
President

APC:sjg

Section 671

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July 16, 1987

FEDERAL EXPRESS

Robert Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act; REMICs

Dear Mr. Leonard:

I would like to propose the following changes to the Technical Corrections Bill of 1987 ("Bill") as it relates to real estate mortgage investment conduits ("REMICs"):

1. The Bill would amend section 860G(a)(3) of the Internal Revenue Code of 1986 ("Code") by striking out the words "directly or indirectly" in the definition of qualified mortgage in section 860G(a)(3)(A). Thus, the statute, after amendment, would define a qualified mortgage as:

> [A]ny obligation (including any participation or certificate of beneficial ownership therein) which is principally secured by an interest in real property...

It is unclear how a partnership interest owned by a REMIC is treated under this definition. I would urge that a technical correction be added to permit a REMIC to hold a partnership interest if that partnership owns qualified mortgages. This is consistent with the treatment of real estate investment trusts ("REIT"s) under Treas. Reg. section 1.856-3.

The chief reason a REMIC should be allowed to own a partnership interest is that, under the 1986 amendment to Treas. Reg. section 301.7701-4(c) [commonly known as the "Sears Regulations"], interests in a mortgage pool that do not meet the specific requirements of the Sears Regulations and the examples therein may be considered interests in a partnership for federal income tax purposes if the mortgage pool has more non-corporate than corporate characteristics under relevant Treasury regulations. In many cases because the Sears Regulations are not entirely clear and have not been interpreted in cases or rulings, counsel will structure a mortgage pool so that if the mortgage pool does not qualify as a fixed investment trust under the Sears Regulations, it will be considered a partnership rather than an association taxable as a corporation. This is particularly the case where the coupon stripping or senior-subordinated features of the mortgage pool are unusual and do not precisely fit the examples in the Sears Regulations. A REMIC may buy such an interest in a mortgage pool and it would seem that, if the mortgage pool were characterized as a partnership for federal income tax purposes, a REMIC could be disqualified unless the REMIC could look through the partnership to determine qualified mortgage status. Therefore, I would propose an addition to section 860G(a)(3) as follows:

> If a REMIC is a partner in a partnership, it shall be considered to own its proportionate share of each of the partnership's assets. Its proportionate share of the partnership's assets shall be determined in accordance with its capital interest in the partnership.

2. The Bill would provide that if any contributions are made to a REMIC after the start-up day, a 100 percent penalty tax would be imposed on the amount of such contribution. It seems to me that this rule is unnecessary and will hamstring a REMIC in ways that Congress did not intend. The change is unnecessary because such contributions, if more than a *de minimis* amount (and if not within the permitted substitution rules), would disqualify the REMIC. It will hamstring the REMIC because there are many events that may be considered contributions which could be subject to the rule. For example, the terms of a regular interst may provide that it can be called at a certain time or if the principal balance of the REMIC's qualified mortgages drops below a certain level. Would a contribution of cash necessary to exercise such a call be a contribution subject to the 100 percent penalty tax? Another problem arises if, in the later years of a transaction, a REMIC does not have enough money to pay its expenses. The sponsor may want to contribute money to pay such expenses rather than have the REMIC default on its regular interests. Will such a contribution trigger the 100 percent penalty tax? It seems to me that this provision will cause far more problems than it is worth--probably in ways that we cannot yet contemplate. I would urge that it be removed from the Bill.

Please call me if you have any questions or would like to discuss these matters further.

Very truly yours,

Thomas A. Humphreys

Sections 671-674

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July 17, 1987

Mr. Robert J. Leonard
Chief Tax Counsel
House Ways and Means Committee
1111 Longworth House Office Bldg.
Washington, DC 20515

Re: REMIC Provisions of Technical
Corrections Act

Dear Mr. Leonard:

This comment letter, including the enclosed technical appendix, on selected aspects of the proposed Technical Corrections Act relating to the treatment of Real Estate Mortgage Investment Conduits (REMICs), is submitted on behalf of our client, Salomon Brothers Inc.

Salomon Brothers has been a pioneering firm in the development of mortgage backed securities for more than 15 years, and is proud of its leading role, working with the Congress, in the development of mortgage finance industry proposals that led to the enactment of the landmark REMIC provisions of the Tax Reform Act of 1986.

The REMIC provisions of the 1986 Act were intended by Congress to increase the availability, and decrease the cost, of mortgage capital for homeowners and others by improving the efficiency of the secondary mortgage market. The specific goal of the REMIC provisions was to enable users of mortgage capital to compete fairly in the capital markets by eliminating inefficiencies imposed by the absence of fair and sensible rules for the structuring and taxation of multiple class mortgage related securities. The success of the REMIC provisions has been clearly demonstrated by the substantial volume of REMICs issued since the Tax Reform Act was signed into law.

Since January 1, 1987, over $20 billion of REMIC securities have been publicly issued by a variety of issuers including affiliates of thrift institutions and mortgage bankers, homebuilders, secondary market agencies, investment bankers, and other traditional participants in the secondary mortgage market.

The staff of the House and Senate tax writing committees, the staff of the Joint Committee on Taxation, and the Office of Tax Policy of the Treasury Department are to be commended for the diligence with which the final provisions of the Act were crafted. Given the technical complexity of the area, and the time pressures under which the final Conference Report was agreed to and drafted, the issuance of over $20 billion of a newly authorized security is a testament to the skill of the professional staff involved in the tax writing process.

As in any legislative effort, however, technical drafting errors are inevitable. In addition, as practitioners begin to work with a statute, new insights develop as to the best technical approach to implementing Congressional intent. The points that follow are intended to comment on the specific proposed technical corrections contained in the Technical Corrections Act as introduced by Chairman Rostenkowski, and to suggest additional areas where statutory corrections and modifications are necessary, in our view, to implement the goals and intentions of the Congress.

In particular, we believe technical corrections should be adopted to make the REMIC provisions as flexible as possible, in light of Congress' intent to establish them as the exclusive vehicle for multiple class mortgage backed securities. Multiple class mortgage backed securities are a critical link in the housing finance delivery system, and have become a significant part of the world-wide capital markets. In light of their demonstrated importance to housing, and their essentially non-tax motivated nature, we believe the guiding rule should be to permit as broad a category of transactions as possible under the REMIC rules, not to artifically limit REMICs where there is no legitimate tax policy concern.

You and your staff should have a justifiable pride of authorship in these important tax rules. We look forward to the opportunity to work with you to further improve them.

Sincerely,

Donald B. Susswein

Donald B. Susswein

Enclosure

Technical Appendix

The following technical comments were prepared by Andrew E. Furer, Vice President of Salomon Brothers Inc, Donald B. Susswein, Partner, Thacher Proffitt & Wood, and James M. Peaslee, Partner, Cleary Gottlieb, Steen & Hamilton. Please direct all inquiries to Mr. Susswein at 1140 Connecticut Avenue, N.W., Washington, DC 20036 or (202) 293-2424.

I. Comments on Provisions of Technical Corrections Act

In general, we believe the provisions of the proposed Technical Corrections Act would make helpful corrections to the REMIC provisions. Certain of the proposed changes, however, are problematic. It is difficult to respond to certain of the provisions about which we have concerns without knowing more about the tax policy rationale or perceived abuse underlying the specific proposed change.

Members of the staff advising the Committee have graciously agreed to meet with us to explain the purpose and intent of the proposed technical corrections, and we hope that our concerns will be obviated. A meeting has been scheduled for Wednesday, July 22, 1987. We hope to be able to supplement this submission, shortly following that meeting, with specific suggestions as to how some of the provisions of the Technical Corrections Act can be tailored more closely to the problems they are intended to address.

For purposes of this submission, however, we would like to highlight several of the more problematic proposals, and to illustrate the difficulties they may create.

1. New Proposed Tax on Post-Startup Contributions to the REMIC

The proposed tax on the contribution of certain amounts to the REMIC after the startup date is an entirely new proposal which, unless its intended scope is clarified, could jeopardize the workability of the REMIC provisions. For example, is it intended that a tax be imposed on payments to the REMIC pursuant to contractual rights held in a qualified reserve fund? Is it intended that reserve funds must be fully funded upon the creation of the REMIC even if the funds are not needed until a subsequent time? Is it intended that a tax be imposed on contribution of funds to a REMIC by holders of residual interests to pay operating costs (such as trustees fees), to pay costs of operating, maintaining or improving foreclosure property pending its distribution or to fund a redemption of regular interests? These and other possible interpretations of this potentially very broad rule threaten the viability of the REMIC provisions. Moreover, as indicated above, there is no indication of the problem or potential abuse to which the proposed tax is directed.

2. New Rules Governing the Formation and Structure of the REMIC.

New rules governing the formation of the REMIC are proposed. These include new limitations on the ability to contribute mortgages to a REMIC during the initial three-month assembly period authorized by the current statute, and a new definition of regular interests. This definition, requiring all regular interests to be issued on the startup date could have the effect of disqualifying the REMIC if, for example, certain obligations of the REMIC to reimburse servicer advances, guarantee payments, and the like were characterized as regular interests. Somewhat vague limitations on the ability to substitute mortgages pursuant to "swaps" are proposed the purpose and intent of which are very unclear. In addition, the requirement that mortgages acquired during the initial three-month period be acquired pursuant to a fixed price contract in effect on the startup day poses problems in the event it is necessary to acquire mortgages in the event the seller does not fulfill the contract. Finally, a proposed technical correction modifying the definition of qualified mortgages so as to exclude collateralized mortgage obligations is proposed with retroactive effect. There was no indication in the legislative history that the statutory definition of qualified mortgages contained a technical error on this point. Accordingly, leaving aside the merits of the proposal, it seems inappropriate to impose a retroactive effective date.

II. Comments on Areas Not Addressed In the Technical Corrections Act

1. Simplification and Clarification of Rules Intended to Ensure that REMICs are Passive, Self-Liquidating Entities

The policy behind the REMIC provisions which limit the ability of a REMIC to replace or dispose of qualified mortgages is clearly the same policy which places limitations on the active management of an arrangement that seeks classification as a grantor trust. The REMIC provisions, even as they would be amended by the Technical Corrections Act, impose a different, and in some cases, a more restrictive set of rules from those under which the mortgage finance industry, and the IRS, have been operating with respect to grantor trust arrangements. Although there are certain aspects of REMIC structure that clearly require different rules, we believe the rules designed to ensure that the REMIC is a self-liquidating, passive investment vehicle should generally be conformed to the rules applicable to grantor trusts. Specifically, we believe technical corrections should be adopted in the area of mortgage dispositions, mortgage substitutions, and mortgage assumptions and modifications that are at least as generous as the rules applicable to grantor trusts. For example, the only restriction upon the disposition of a mortgage loan during the life of a grantor trust is that there be no reinvestment of the proceeds of such repurchase, since the IRS has held that the ability of a trustee to sell trust assets does not represent discretionary power to vary the investment or active management. *See* Rev. Rul. 78-149, 1978-1 C.B. 448. *Also see* Rev. Rul. 71-399, 1971-2 C.B. 433 (dealing with substitutions); Rev. Rul. 73-460, 1973-2 C.B. 424 (dealing with loan modifications).

2. Treatment of Interest-Only Certificates As Regular Interests

The Blue Book has already provided helpful clarification of a number of provisions intended to address the creation of mortgage investments backed principally or exclusively by interest payments on underlying mortgages. Such investments have become important tools to attract mortgage capital by creating instruments that more closely match mortgage cash flows to investor preferences.

Under the existing statutory structure, so-called interest-only instruments are not intended to qualify as regular interests, but may qualify as residual interests. Moreover, as the Blue Book explains, an instrument with a stated principal amount that bears disproportionately high interest also is not intended to qualify as a regular interest but will be treated either as a residual interest or as a combination of a regular and a residual interest. (For purposes of the remainder of this discussion the term "interest-only instrument" is used to refer to instruments bearing "disproportionate" interests as well as instruments backed exclusively by interest payments.) Given the statutory rule against issuing more than one class of residual interests in the same REMIC, common transactions involving more than one class of interest-only investment may not qualify in their entirety for REMIC treatment.

One method of creating more than one interest-only instrument backed by the same pool is to create a stripped regular interest under the Code's coupon stripping rules, inasmuch as the regular interest is treated as a bond. The Blue Book comments on, and approves, what has become another method of structuring such transactions: separating or "stripping" an interest-only investment off of a mortgage under the Code's coupon stripping rules, and then contributing to the REMIC only the remaining portion of the mortgage. The Blue Book explains,

> "[W]here the REMIC's qualified mortgages are stripped coupons or stripped bonds (within the meaning of section 1286), Congress did not intend that any other stripped coupons or stripped bonds arising from the same debt instruments as the qualified mortgages would be treated as a second class of residual interest in the REMIC."

Although this clarification of Congressional intent is helpful, we believe there may be a simpler way to facilitate these structures, which will also have several other salutory effects.

We would recommend that the definition of regular interests be modified specifically to include interest-only certificates, by allowing regular interests to be issued with a "notional" principal amount. Thus for example, a stream of interest-only payments, based on a fixed or variable rate as applied to an identified principal amount would qualify as a regular interest even though the specified principal amount would not be paid to the holders. Under this approach there would be no rule recharacterizing, in whole or in part, regular interests bearing disproportionately high interest as residual interests. Holders of such regular interests would be appropriately taxed, like holders of all other regular interests, under the original issue discount rules for REMIC regular interests.

In addition to eliminating the non-tax legal complexity and possible investor confusion involved in identifying specified cash flows on qualified mortgages as being "inside" or "outside" the pool of assets subject to a specific REMIC election, this approach should result in a more accurate measure of the income of holders of stripped mortgage backed securities qualifying as REMIC regular interests. If stripped mortgage instruments issued outside of a REMIC are to be subject to the Treasury Departments proposed regulations on OID, the OID on such instruments will apparently be calculated under the rules for debt instruments with contingent payments, a method that may provide a less accurate measure of income than the OID rules applicable to REMIC regular interests under Code section 1272(a)(6). In addition, interest-only investments qualifying as regular interests, as opposed to stripped coupons outside of a REMIC, would be subject to the expanded information reporting required by the REMIC provisions.

Although holders of regular interests with a notional (or nominal) principal amount would, in many cases, include OID in income more accurately, and more rapidly, than if they were issued as stripped coupons subject to the Treasury Department's proposed regulations, clarification would be needed of the treatment of losses on such instruments attributable to mortgage prepayments. In the case of an interest-only instrument, mortgage prepayments have an effect equivalent to that of a principal loss on a mortgage or mortgage passthrough because when a mortgage prepays the holders right to future interest payments is extinguished. We would be happy to work with the technical tax staff advising the House and Senate tax writing committees to develop an appropriate approach to this problem.

3. Excess Inclusion Rules

We believe the excess inclusion rules, and the special wash sale rules applicable to residual interests, are seriously flawed and do not serve their intended purpose. The purpose of the excess inclusion rules, as we understand them, was to create an approximate measure of that portion of the taxable income on a residual interest that exceeded the interest's economic income, so that the economic income could be subjected to the normal tax rules applicable to the holder, while the taxable income that exceeded economic income would be subject to special rules intended to ensure that such income would not escape taxation by virtue of the holder's tax exempt status or (except in the case of thrift institutions) net operating losses of the holder.

The excess inclusion rules, as currently drafted, characterize entirely too much taxable income as being in excess of an economic return in circumstances where the real economic return of a residual interest exceeds the assumed economic return provided for in the statute. This has impeded the sale of residual interests to pension plans and foreign investors in circumstances where no tax policy concerns are present. In addition, the rules fail to account properly for circumstances where, on a cumulative basis, a residual interest does not produce taxable income in excess of an economic return, although it may do so in a particular calendar quarter. In addition, the excess inclusion rules do not provide a mechanism for the refund of taxes paid on nonexistent income, once the acceleration of taxable income reverses itself and results in taxable income lower than real economic income.

We would be happy to work with the staff to improve the excess inclusion rules or to develop an alternative approach to address their underlying policy concern. We submitted one suggestion to the staff near the end of last year's tax conference; we have begun to review other approaches which may also be feasible.

4. Treatment of Foreign Holders of Regular and Residual Interests.

We believe it should be clarified that the holders of residual interests are not subject to the 30% withholding tax except on amounts in excess of a reasonable economic return, as determined under appropriately modified excess inclusion rules or some alternative approach. This would conform their treatment to that of equity interests in owner's trusts. In addition, the treatment for estate tax purposes of regular interests held by foreigners should be conformed to that of foreign holders of other debt instruments.

5. Minimum/Maximum Prepayment Guarantees

We understand that Congress intended REMICs to be the exclusive vehicle for issuing multiple class mortgage related securities, after a five year transition period intended to ensure that the REMIC vehicle is "appropriate and serviceable" for this purpose. Under the current statute, and in the absence of clarifying Treasury regulations, it is unclear whether REMICs may provide for the issuance of Regular Interests or Residual Interests that are subject to maximum or minimum prepayment guarantees.

Minimum prepayment guarantees have already become a feature of some well known issues of collateralized mortgage obligations. Substantial research and development efforts are being undertaken to create CMOs with maximum prepayment guarantees. In the absence of statutory or regulatory clarification of the permissibility of these structures under the REMIC rules, the REMIC vehicle will clearly be inappropriate as the exclusive vehicle Congress intended to create. In addition, to the extent issuers are forced to issue CMOs instead of REMICs solely because of their inability to provide for these guarantees, the Government may lose revenue that would otherwise be generated from the taxable gain that is recognized upon a sale of assets under the REMIC rules, but which is not recognized upon the issuance of a debt instrument.

Although we are not aware of any technical problems or tax policy concerns in this area, if the staff has any concerns we would be happy to work with the staff to develop appropriate modifications to the REMIC rules to facilitate minimum and maximum prepayment guarantees.

In the alternative, if the conclusion is reached that minimum and maximum prepayment guarantees are, for some reason, incompatible with the structure of the REMIC rules, we believe that multiple class mortgage pools having such guarantees should be exempted from the taxable mortgage pool rules which require multiple class mortgage pools to be structured as REMICs.

6. Reserve Funds

We believe a number of statutory clarifications are needed in relation to the REMIC provisions for qualified reserve funds. In the first place, we believe the definition of a reserve fund asset as an asset "held for investment" should be deleted, since it does not describe guarantees and other contracts that are held by the REMIC for permissible reserve fund purposes.

Secondly, we believe it should be clarified that, consistent with the statutory goal of keeping reserve funds as low as possible, it is permissible to add cash (either from mortgage payments or from fresh funds paid to the REMIC) to reserve funds from time to time after the REMIC is formed if that is a reasonable course of action in light of the purposes of the reserve. In the absence of such a rule, reserve funds that might not be needed in the early years of a pool would have to be provided in cash at the commencement of the REMIC. In addition to the added cost of such an approach to the issuer or sponsor of the REMIC, it would not serve the Congressional purpose of keeping reserve funds as low as they could otherwise be. Where such reserves are intended to inure to the residual class, if not called upon, the statute should permit an increase in the basis of the residual interest for such additions to the reserve fund. Alternative approaches to this problem may also be feasible.

In addition, we believe the permissible purposes for reserve funds should be expanded to include reasonable debt service reserves. For example, in the case of a REMIC supported by graduated payment mortgages, it would be desirable to include a cash reserve fund for the purpose of providing regular interest holders with level cash payments that could not be supported by the mortgages themselves in early years. In addition, many mortgage securities provide reserve funds to compensate for a two-month delay in the receipt of payments following acquisition of certain FHLMC (Freddie Mac) mortgage securities.

7. REMIC As Individual

We note that at least one problem associated with the treatment of the REMIC as an individual, for tax computational purposes, has been addressed by the Technical Corrections Act. The Technical Corrections Act clarifies that losses passed through to the holders of residual interests are to be treated as ordinary losses. We believe it may be desirable to consider other unintended consequences following from the treatment of the REMIC as an individual, for tax computational purposes. We would be happy to provide additional information on this point to the staff.

8. Amortization of Bond Premium

The final specifications for the REMIC provisions expressly provided for premium amortization on REMIC mortgage assets to the same extent that such assets, if acquired at a discount, were to be subject to a mandatory section 1278(b) election. The agreement of the Conferees on this point, as well as many other points, was a critical aspect of the final negotiations with industry representatives on the REMIC provisions. The Technical Corrections Act should ensure that the REMIC provisions incorporate this point.

As we read the statute, all mortgages held by a REMIC are subject to a mandatory section 1278(b) election, and, accordingly, all mortgages held by a REMIC should be eligible for premium amortization under Code section 171. (If our reading of the scope of the mandatory section 1278(b) election rule is incorrect, then clarification of its proper scope would be appropriate in conjunction with clarifying what we believe should be the coextensive applicability of Code section 171 to REMIC mortgage assets).

The REMIC provisions, however, fail to provide special rules allowing for amortization of premium on mortgages. Although the technical corrections provisions of the 1986 Act allow for premium amortization on mortgage loans generally, they do so only with respect to mortgages originated after September 27, 1985. We believe a technical correction is appropriate to allow for amortization of premium on REMIC qualified mortgages without regard to their origination date.

9. Qualified Liquidation Rules

We believe the qualified liquidation rules should be modified to allow the distribution, in lieu of a sale, of the REMICs assets to holders of regular or residual interests in the REMIC. Such a distribution should be a nontaxable event to the REMIC, and the holders of interests should take the property distributed by the REMIC with a substitute basis. We believe guidance on this point should be drawn from relevant analogies in the partnership area, or from the tax treatment that would result if the holders of residual interests acquired all of the outstanding regular interests in the market.

9. Prohibited Transaction Payments

We believe it should be clarified that the payment of a prohibited transaction tax by a party other than the REMIC, or the reimbursement to the REMIC of such a tax, will not itself be a prohibited transaction. The purpose of the prohibited transaction rules is served by the confiscation of all income from a prohibited transaction. It does not conflict with this purpose for the issuer or sponsor of the REMIC to provide or procure a guarantee that the holders of interests in the REMIC will not be adversely affected in the event a prohibited transaction occurs. Such guarantees can be provided outside of the REMIC, and should be permissible within the REMIC structure.

10. Measurement of Qualifying Assets

Under the REMIC provisions as enacted, a regular or residual interest will generally be treated as qualifying assets for purposes of sections 593(d) and 7701(a)(19) and as real estate assets as defined in section 856(c)(3)(C) in the same proportion that the assets of the REMIC would be treated as qualifying under those sections. If, however, more than 95% of the assets of the REMIC consist of such assets, then the entire interest in the REMIC will be considered as qualifying under those sections. Under section 7701(a)(19), the determination of whether a building and loan satisfies the qualified assets test is made as of the close of the taxable year (or, at the election of the taxpayer, based on the average assets outstanding during the taxable year). Likewise, the regulations under section 593(d) provide the same testing convention. The REMIC-related amendments to section 7701(a)(19) and section 593(d) suggest that the same testing conventions are to be used in determining the percentage of a REMIC's assets that constitute qualifying assets. In particular, section 593(d) suggests that the determination of the percentage is to be made "as if the taxpayer held the assets of the REMIC."

The Conference Report and the Blue Book, in footnotes to the explanation of the REMIC provisions, state that, in order to satisfy the 95% test, the assets of the REMIC must qualify "at all times during the taxable year" for such treatment. However this statement does not, by its terms, apply to the determination of the percentage of assets that will be treated as qualified assets if the 95% test is not satisfied.

We believe there is a need for clarification of a possible contradiction between the statute and the language of the Conference Report. In addition, as a matter of sound policy and tax administration, we do not see any reason why the testing rules applicable under the relevant Code sections (e.g., sections 593, and 7701(a)(19)) should be supplanted in determining the percentage of a REMICs assets that qualify. In particular, a daily determination of the REMIC's assets could be difficult to administer. We would be happy to work with the staff to develop a workable rule for the timing of the determinations required by the statute.

In addition, the REMIC provisions do not provide guidance as to which assets of the REMIC are to be included in the ratio for purposes of the 95% test. Under various IRS rulings in the grantor trust context, GNMA, FNMA or FHLMC pass-through certificates qualify entirely as qualifying assets for thrifts and REITs notwithstanding the fact that the assets underlying the certificates may include not only qualifying mortgages, but also payments held pending distribution to certificateholders or servicer advances (including, but not limited to, protective advances of taxes or insurance). In the REMIC context, cash flow from the mortgage loans held by the REMIC pending distribution or servicer receivables are likely, at times, to exceed the 5% threshold. Without clarifying legislation, there is a significant threat that these amounts will disqualify REMIC interests as qualifying assets for thrifts. We therefore recommend that cash flow investments or amounts that represent a receivable from the servicer be characterized in the same manner as the related mortgage for purposes of determining the status of REMIC interests as qualifying assets.

11. Recovery Of Unrealized Loss Or Gain On Contributions

Under section 860F(b)(1)(A), no gain or loss is recognized by the transferor on the transfer of any property to the REMIC; such nonrecognition will be limited to circumstances where such transfer is in exchange for a regular or residual interest in the REMIC under the Technical Corrections Act. The rules under this section provide that, with respect to regular interests, the unrecognized gain is to be included in income pursuant to rules similar to those under section 1276(b), and the unrecognized loss is amortized under rules similar to those under section 171.

Holders of residual interests, however, are required to include the unrecognized gain or amortize such unrecognized loss in income over the "anticipated period during which the real estate mortgage pool (sic) will be in existence." While the reference to "real estate mortgage pool" rather than a "real estate mortgage investment conduit" appears to be a technical oversight from earlier versions of the REMIC legislation, we believe that additional technical corrections to this provision are required.

We believe the technical correction should provide that unrecognized gain or loss in the case of a residual interest should be taken into account over the weighted average life of the residual interest. (The anticipated life of a REMIC may significantly exceed the weighted average life of the residual, merely because there is a relatively insignficant portion of the pool outstanding for a long period of time.) For purposes of this rule, the weighted average life should be determined in a manner consistent with the prepayment and reinvestment income assumptions used in computing original issue discount on regular interests.

12. Information Reporting

REMICs and issuers of interests in REMICs are subject to the information reporting requirements imposed under sections 1275 and 6049 of the Code. Furthermore, the exception to the reporting requirements in section 6049(b)(2), applicable to corporations and certain other entities, is eliminated. In addition, the Secretary is authorized to issue regulations requiring the reporting to holders of residual interests such information as frequently as is necessary or appropriate to permit such holders to compute their taxable income accurately.

The provision of regulatory authority to require more frequent than annual reporting is indicative of the fact that information reporting in the form of the traditional annual Form 1099 may not be a workable or practical approach. In addition to problems that may be posed for fiscal year taxpayers, many corporations may not have facilities or procedures for the collection of information from paper information reports.

Corporations holding publicly issued bonds issued with original issue discount are accustomed to obtaining their income reporting information from the IRS publication relating to OID on such bonds. The creation of an IRS publication for REMIC tax information, in lieu of annual (or more frequent) paper information returns, would be desirable. To the extent statutory changes are needed to implement this goal, we would recommend that the Technical Corrections Act incorporate them. We would be happy to work with the staff, and the staff of the Treasury Department and the IRS, to implement this concept.

13. Cash Flow Investment Rules

We believe modifications to the cash flow investment rules are needed to accommodate reasonable administrative difficulties involved in distributing amounts received shortly before a regular distribution date. In short, some reasonable grace period is necessary. We would be happy to work with the staff to develop appropriate modifications to the REMIC provisions in this area.

14. Taxable Mortgage Pools

We believe the rules governing taxable mortgage pools may prohibit transactions which the Congress did not intend to prohibit. In particular, we do not believe that the Congress intended to limit the ability of corporate issuers of multiple class mortgage backed securities to file a consolidated return with members of their affiliated group. The effect of this rule would be to preclude the "plain vanilla" CMO, billions of dollars of which have been issued with no suggestion that there is a tax policy concern involved in their issuance. Indeed, we understood that the Conferees' intention was not to limit, under the taxable mortgage pool rules, multiple-class securities issued by corporations subject to a two level tax. In addition, the application of these rules to other transactions may have other unintended consequences which we believe should be revisited.